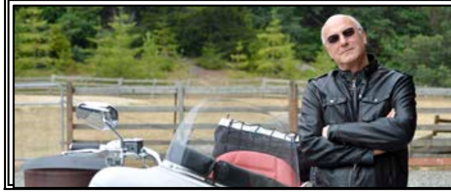


Michael A. Gordon, CPA, LLC **(an S corporation)**
"Not Your Basic Bean Counter"
290 S. 4th Street, Coos Bay, Oregon 97420 541-269-1272

Today's date

IRS DISLIKES BUSINESSES SHOWING LOSSES

Name
Address
City, State, Zip

Greetings!

We are giving you this letter because your farm/business activity has been showing losses for some time now. No need to panic…but, the IRS has publicly declared that they are going to be stepping up their audits on exactly this kind of situation. They don't like taxpayers showing farm/business losses. They would like to disallow the losses in excess of the income!

Not only so, but in June 2009 they released what is called an *Audit Technique Guide* on this very subject. An *Audit Technique Guide* is, basically, a training manual for IRS auditors on specific topics to guide them when they are auditing you. No kidding.

The big question
If the IRS (or Oregon, for that matter) were to audit your tax return and try to say that your "farm" or "business" was just a "hobby" (which could mean that they would disallow a LOT of the deductions), are you able to defend your position?

How do you do that? Well, the courts look at 9 factors. Now, to be fair, we've discussed these with most of our clients in the past. The vast majority of our clients feel they would have no problem showing the IRS that they are, in fact, involved in a "hobby".

So…why the fuss?
It never hurts to be OVER-PREPARED, right? And since the IRS is definitely on the warpath about this, I think it behooves us to understand just what the enemy (IRS) is going to be fighting with. Do you agree? I hope so. I would hate for any of my clients to be hurt by such an IRS audit.

Okay, what's the BEST thing you can do?
The absolute BEST thing you could do is to print out the Audit Technique Guide on this subject and read it in its entirety. I don't imagine many of you are inclined to do that! But it would benefit you greatly. It will surprise you in its detail.

So…what's the SECOND BEST thing you can do?

So, you don't want to read this long document, huh? I understand. So, SECOND best is for you to read the sections of it that I have printed and attached to this letter. How's that for service?

2 attachments for you to read

I have attached Appendix A and Appendix B of the *Audit Technique Guide* for you to read. Appendix A discusses EACH of the 9 factors and what the issues are. It's a really good discussion. You will learn a lot….seriously. Appendix B is the actual list of questions that the IRS auditors are supposed to ask you during the audit! You won't believe how LONG the list is!

Some encouragement

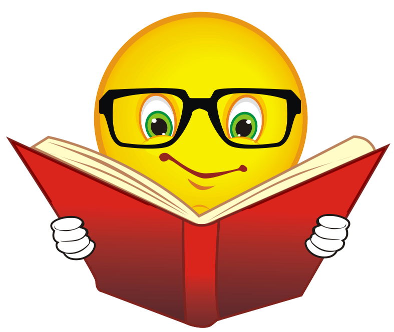
Honestly, reading both appendixes will only take you about one hour. You will have gained an enormous amount of information about how to protect yourself if the IRS ever wants to audit you about this "hobby loss" issue. We've even heard that they are going to instruct their computers to pull aside any business or farm showing losses and review it for potential audit! Then they will decide which ones to go after. I'm not sure I believe that rumor but, as I said earlier, why not be OVER-PREPARED?

Do we need to have a meeting?

I will leave that up to you. We are always, of course, available to meet with you and discuss any of the items in this letter and the attached appendixes. If you would like to do that, please call and set up an appointment with either myself or my staff. We'll be delighted to help you ensure that your business is audit proof.

Thanks so much for your confidence in us. Taking care of you is our highest priority!

And……happy reading!



Sincerely,

Michael Gordon, CPA

Appendix A - Treas. Regs. § 1.183-2(b)

The nine relevant factors used to evaluate whether an activity is engaged in for profit with a brief explanation of each factor are included below.

Factor 1

(1) Manner in which the taxpayer carries on the activity. - The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

The examiner needs to inquire about the books and records maintained for the activity during the Initial Interview. The examiner should document in the workpapers regarding the sophistication of the taxpayer's books and records. The examiner should determine if the taxpayer maintains checking accounts for the activity which are separate from the accounts used for the taxpayer's personal living expenses.

Depending upon the volume, the examiner should obtain photocopies of the taxpayer's entire set of books and records. If photocopying the entire set of books and records proves to be cost prohibitive, the examiner should only photocopy samples representative of the overall books and records.

The presence of sophisticated books and records does not automatically equate to profit motive. The taxpayer must be relying upon these records in order to operate the activity and make decisions or changes. The examiner needs to document how these records are utilized by the taxpayer.

The taxpayer should have a formal written Business Plan. This plan should demonstrate the taxpayer's financial and economic forecast for the activity. The plan should not be a "fantasy profit and loss statement." In other words, some taxpayers may wish to submit a business plan that is nothing more than a Schedule F or C, which unrealistically overstates the gross receipts and unrealistically understates the expenses for the activity.

The examiner should not request the business plan in the first IDR. Otherwise, the examiner will possibly receive a "canned" document. The examiner should inquire as to the business plan during the Initial Interview and follow-up with a subsequent appointment and/or IDR.

A business plan should show a short range and long range forecast for the activity. The forecast should allow for changes due to potential unforeseen and fortuitous circumstances.

The plan should be realistic. The examiner should perform quantitative analyses in order to determine the reasonableness of the projected gross receipts and various expense items. The examiner may consult with IRS economists in order to review the business plan.

The examiner should determine if the taxpayer followed the plan and if the original plan was not successful did the taxpayer made any amendments to the plan to increase profitability.

The examiner needs to document the taxpayer's method of operation. The examiner should document the daily operation as well as the history of the activity's operation in the workpapers. Denote changes in the method of operation over the years and indicate why these changes were initiated. Most of this information will be gathered during the Initial Interview.

The examiner needs to document the efficiency of the taxpayer's operation. Denote the taxpayer's use of any experts or specialists. Indicate if any changes were initiated and why. Obtain names, position titles, and addresses. Most of this information will be gathered during the Initial Interview.

The examiner will note whether the taxpayer is making changes to the operation that will result in improved operational efficiency.

The examiner needs to review the actual copy of any advertising in instances where the taxpayer has deducted such expenditures. Many taxpayers will buy advertising space for "vanity" ads. These spaces are sometimes purchased to place photographs of their children. These ads may wish the children "Best of luck" prior to upcoming competitions. The examiner should use professional judgment to determine whether the advertisements truly represent promotion of the taxpayer's activity.

The examiner needs to be alert for the children's activities being deducted on the parents' tax return. The examiner needs to review reports and determine who actually competes in certain activities. The parents may contend that the children are promoting the activity through the competitions. The examiner needs to consider the substance of the facts.

Depreciation and Inventory can be viable issues for the examiner to consider as an aside from IRC § 183. The examiner should develop a clear understanding of the taxpayer's activity and verify that the proper tax treatment is used for the activity.

Summary of Factor 1

The examiner must document the manner in which the taxpayer carries on the activity. Most of this information will be gathered during the Initial Interview and the tour of the operation. It is important for the examiner to document a clear understanding of the activity. Assumptions should not be made that each activity operates the same as another similar activity.

Factor 2

(2) The expertise of the taxpayer or his advisors. - Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

Factor 2 addresses the expertise of the taxpayer or his or her advisors. The examiner should document the extent to which the taxpayer has relied upon his or her advisors. The examiner should also document the instances where the taxpayer received advice from his or her advisors, but failed to heed this advice.

The Initial Interview should include questions regarding the taxpayer's expertise, the use of any experts, and any changes or decisions regarding the operation of the activity.

The examiner should establish and document the taxpayer's background in the activity and determine how long the taxpayer has been engaged in the activity. Many times the taxpayer was involved in the activity in some capacity during youth and later became involved again as an adult. These adults have re-entered the activity after they have obtained the financial wherewithal to commence the activity. The examiner should establish a history of the taxpayer's growth of knowledge within the activity and how this knowledge was obtained.

The examiner should establish if the taxpayer has used any advisors or experts in the operation of the activity. Obtain names, position titles, and addresses of these advisors. Document how the advisors were chosen by the taxpayers. Establish the credentials of the advisors. Document if a personal relationship exists between the taxpayer and his advisors.

The examiner needs to document specific instances where the taxpayer was provided advice that was implemented in the activity. Describe how this information affected the operation and any resulting changes. Document whether the advised changes were successful or unsuccessful.

The examiner also needs to document specific instances whereby the taxpayer was advised by his or her experts to make changes and the taxpayer ignored the advice. The examiner should document why the taxpayer chose to ignore this advice. Many taxpayers will provide names of advisors in an effort to demonstrate profit motivation. However, if the taxpayer chooses not to implement the suggested changes and cannot provide just cause for doing so, then the taxpayer's use of advisors is questionable.

Summary of Factor 2

The examiner should document the expertise and knowledge of the taxpayer regarding the activity. The examiner should also document any advisors or experts that the taxpayer has used. Documentation should be prepared which shows specific instances where the taxpayer has followed the advice of the advisor.

Documentation should also show how the advice affected the operation of the activity. The examiner should especially note instances when the taxpayer has ignored the recommendations of the advisor and why that decision was made.

Factor 3

(3) The time and effort expended by the taxpayer in carrying on the activity. - The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

This factor addresses how much time and effort is expended by the taxpayer in carrying on the activity. In addition to the taxpayer’s time, the examiner needs to consider the amount of time expended by any other individuals involved in the activity. The development of this factor may lead to the development of an alternative position under the provisions of IRC § 469 for Passive Activities.

The examiner needs to establish precisely how much time the taxpayer devotes to this activity as well as all other activities. The amount of time devoted to the activity may be an indicator of profit motive. If the taxpayer devotes a limited amount of time to the activity, then the taxpayer may be lacking a profit motive. However, if the taxpayer employs competent and qualified individuals to operate the activity, then the taxpayer’s time and effort will be reduced. Time and effort expended reading magazines, journals, and other periodicals are consistent with engaging in a hobby.

After the examiner determines the amount of time that the taxpayer devotes to the activity, then the examiner should consider the possibility that the provisions under IRC § 469 may apply to the taxpayer. If the examiner determines that IRC § 469 may be applicable, then the examiner could use IRC § 469 as an alternative position to IRC §183.

The examiner should prepare an analysis that shows how much time is devoted to the activity as well as a breakdown of how that time is spent. For example, the examiner should designate how much is spent attending seminars, reading magazines and journals, or how much time is spent performing repairs and maintenance and so forth.

The examiner should note specifically the amount of time that the taxpayer devotes to other activities.

Summary of Factor 3

The examiner should consider the amount of time that the taxpayer devotes to the activity. The time analysis should precisely detail how much time the taxpayer devotes to each task related to the activity. The examiner should consider whether IRC § 469 Passive Activity provisions might be applicable. IRC § 469 could provide an alternative position for IRC §183.

Factor 4

(4) Expectation that assets used in activity may appreciate in value. - The term “profit” encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of §1.183-1(d) for definition of an activity in this connection.

A taxpayer’s “profit” expectations may include appreciation in the value of assets used in the activity. The courts have differed in their application of this factor. Some have included unrealized appreciation in boats, limousines, equipment and real property in determining if the taxpayer had a bona fide profit motive.

Factor 4 has been the most difficult of the nine relevant factors for examiners to correctly develop. The taxpayer has generally been successful with respect to this factor because of the potential for land appreciation. However, proper development of this factor can overcome the potential for land appreciation.

Factor 4 hinges on whether the operation of the taxpayer’s activity and the holding of the land are considered to be a separate or single activity.
According to the Treasury Regulations, Factor 4 states that the term “profit” also includes the appreciation of assets, such as land, used in the activity. An overall profit may occur, in spite of losses from current operations, if the appreciation of the assets is realized.

The examiner needs to prepare an analysis that shows the history of the activity. Beginning with gross receipts, the examiner needs to separate current operating expenses from the costs of carrying the assets. These carrying costs would include depreciation and related interest expense.

The examiner needs to determine if gross receipts exceed current operating expenses with a resulting net profit. For the purpose of this calculation, depreciation expense and related interest expense should be excluded.

As previously mentioned, taxpayers can frequently show potential appreciation of asset value, usually with respect to the land. However, the appreciation of the assets may only be used as a consideration for overall profitably if the operation of the activity and the holding of the assets are considered to be a single activity.
If the operation of the activity and the holding of the assets are considered to be separate activities, then the appreciation of the assets will not be considered for overall profit. In other words, if the operation of the activity and the holding of the assets are considered to be separate activities, the history of operational losses cannot be offset by the potential gain from asset appreciation.

In order to show that the operation of the activity and the holding of the assets should be treated as separate activities, the examiner needs to refer to the previous analysis. If gross receipts do not exceed current operating expenses, then the operation of the activity and the holding of the assets will be considered as two separate activities. As two separate activities, the history of losses cannot be offset by the appreciation of the assets.

Factor 4 relies upon future asset gain potential to offset current losses. The examiner should inquire during the Initial Interview if the taxpayer intends to retire on the site. Frequently taxpayers have purchased these properties for the purpose of future retirement. If the taxpayer intends to retire on the property, then no future gain will be realized. Tax Court cases have gone both ways with respect to taxpayers who have expressed retirement purposes as an intention for land acquisition. Nonetheless, the examiner should document such intentions, if known. Since no one factor is determinative by itself, the examiner should address the taxpayer’s intention for holding the land.

The examiner should consider the potential for appreciation of the activity assets, especially the land. This information can be gathered from comparables.
Comparables would show land values for properties similar to the taxpayer’s parcel. Comparables can be obtained from area realtors. Comparables are extremely important in determining land valuation. The potential for asset appreciation should be documented on a separate workpaper in the examiner’s case file.

Summary of Factor 4

The examiner needs to determine if a potential for asset appreciation exists within the activity exists. The examiner also needs to determine whether the operation of the activity and the holding of the land are considered a single activity or separate activities. In the instances of single activities, the history of losses from current operations will be offset by the future potential gain. In the instances of separate activities, the taxpayer cannot offset current operating losses by future potential gains. A determination of separate activities will frequently result in the taxpayer not meeting Factor 4.

Factor 5

(5) The success of the taxpayer in carrying on other similar or dissimilar activities. - The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

The examiner needs to document the taxpayer's financial success in other activities. This information will be gathered from prior year tax returns as well as the years under examination.

The examiner will prepare a worksheet that details the history of other activities.
This detail should show the profits and losses derived from the activities. In general, many taxpayers have achieved financial success in other business endeavors and yet failed in the operation of the activity in question.

The examiner should focus on activities in addition to the taxpayer's primary source of income. For example, if the taxpayer is a medical doctor, the examiner should not focus on his or her success with his or her medical practice. The examiner should focus on success or failure of other unrelated ventures that were conducted in addition to the medical practice, such as the operation of a restaurant or a kennel.

In addition to the aforementioned worksheet, the examiner needs to document any specific instances where the taxpayer has abandoned certain activities when those activities have proven to be unsuccessful.

Summary of Factor 5

The examiner needs to document the financial successes that the taxpayer has had with other activities. A statement should also address specific instances where the taxpayer has abandoned any activities.

Factor 6

(6) The taxpayer's history of income or losses with respect to the activity. - A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

The examiner needs to document the history of income or losses generated by the activity. This documentation should be prepared on a detailed worksheet with any narrative as necessary. While this factor may present the taxpayer in a negative light, examiners should not use this relevant factor by itself in reaching a conclusion regarding the profit motive of the activity.

Some of the nine relevant factors will overlap through the course of the examination process. Information developed for one factor may be used in the development of other factors. Factor 6 is one of the most important factors of the nine. This factor supports the framework of this Code section.

The examiner needs to prepare a worksheet that shows a history of the activity's profits and losses such as that shown in **Appendix D.** The examiner will need to gather prior year tax information using Integrated Data Retrieval System (IDRS). The examiner should order the original returns for any prior years that are no longer "online." These returns would be ordered for review purposes using local procedures. The examiner can copy the original returns and place them in the administrative file. The taxpayer can also be requested to provide copies of the applicable returns.

The examiner should prepare the worksheet with a separate column that shows the amount of depreciation that was deducted in each tax period. This separation is required for use in the development of other relevant factors. If the taxpayer has deducted other land carrying costs, such as real estate taxes or related interest expense, then these expenses should be shown in a separate column. Such real estate taxes and mortgage interest would be deductible on Schedule A subject to AGI phase-out limitations.

Summary of Factor 6

IRC § 183 focuses on the lack of profit potential for a specific activity. The question regarding profit motive is initially triggered by history of losses. For this reason, the development of this relevant factor provides the framework for this section. Examiners should not base any conclusions using this relevant factor alone.

Factor 7

(7) The amount of occasional profits, if any, which are earned. - The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

The examiner needs to address the amount of occasional profits that the taxpayer has derived from the activity. In most instances where the provisions of IRC § 183 are considered, the taxpayer will have few profits, if any.

The examiner needs to consider whether the taxpayer has generated any profits from the activity. A worksheet would be a useful tool in showing these profits or the lack thereof.

The examiner should pinpoint the exact source of the gross receipts reported for the activity on the tax return. There have been instances where taxpayers have reported gross receipts, which were derived from sources other than the activity, onto the Schedule for the activity. The misplacement of income may be an error, or it may be a deliberate attempt to show revenue where revenue did not exist.

If the examiner determines that certain gross receipts were mistakenly reported on the activity's Schedule, the examiner should not include these gross receipts in any of the worksheets prepared for the purpose of developing the IRC § 183 issue. If any worksheets are prepared with the omission of any such gross receipts, a footnote should be included on each worksheet disclosing such omission.

Example

A Schedule C for a dog breeding activity contained gross receipts for $3,200.
Upon further development, the examiner discovered that the entire amount of the gross receipts pertained to a separate activity, other than the dog breeding.
The examiner did not include the $3,200 of misplaced gross receipts in any worksheets during the development of the IRC § 183 issue. The examiner did incorporate footnotes that disclosed that $3,200 of gross receipts was erroneously reported on the Schedule C.

If as in the aforementioned example, a significant sum of gross receipts was misreported on the activity's Schedule and significant misrepresentation for the profitability results, the examiner should consider the implications of such misplacement. Civil fraud may be a consideration depending upon the overall impact.

If the examiner in the previous example had not excluded the misplaced gross receipts from the various IRC § 183 worksheets, then a true picture of the taxpayer's activity would not have been portrayed.

Some taxpayers have fabricated income for the activity in an effort to put forth an appearance of profit motive. The examiner needs to verify the income. Such fabrication raises consideration of potential fraud.

Summary of Factor 7

The examiner should consider the amount of occasional profits that the activity may generate. However, the examiner should determine the source of the gross receipts just in the event the gross receipts have been misreported on the tax return. Such misplacement could misstate the profitability of the activity and should be removed from the IRC § 183 issue development with footnotes or disclosures to that effect.

Factor 8

(8) The financial status of the taxpayer. - The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.

This factor addresses the financial status of the taxpayer. In some instances, the taxpayer may have the financial wherewithal to sustain a history of financial losses for the activity. Certain taxpayers may receive a tax benefit from the losses incurred by the activity as these losses will offset other substantial sources of income.

In general, taxpayers with other substantial sources of income have the financial wherewithal to sustain significant losses from activities that appear to meet the criteria of the provisions set forth under IRC § 183.

Misinformation has been written that advises taxpayers to enter into certain activities for the purpose of deriving a tax benefit. Taxpayers with other substantial sources of income have the financial wherewithal to enter such activities irrespective of the motivation. The examiner needs to understand why the taxpayer has not abandoned an unsuccessful activity when other taxpayers who lack the same financial wherewithal would most likely abandon the unprofitable activity.

Many Tax Court cases have been pursued which involve taxpayers that have other substantial sources of income that have engaged in historically unprofitable activities without abandonment. In general, taxpayers who have other substantial sources of income have not faired as well in Tax Court litigation as taxpayers who do not have such financial wherewithal.

The examiner needs to document the financial status of the taxpayer in the workpapers. The examiner should also make a statement to the effect that the financial status has enabled the taxpayer to sustain a history of losses in the activity.

Earlier text directed the examiner to prepare a tax savings benefit analysis. This spreadsheet would show possible motivation for certain taxpayers to continue participation in an unsuccessful financial endeavor.

Summary of Factor 8

In general, taxpayers who have other substantial sources of income have the financial wherewithal to sustain a history of losses with respect to not for profit activities. Some taxpayers actually derive a tax benefit from participation in these activities since the losses offset the other sources of substantial income.

Factor 9

(9) Elements of personal pleasure or recreation. - The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, 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. 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. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

Section 183 has been referred to as the “hobby loss” section because many taxpayers have engaged in unprofitable activities due to the pleasurable attributes of the activities. Factor 9 addresses the elements of personal pleasure or recreation of the activity.

The examiner must develop an understanding of the taxpayer’s activity. This understanding must be documented in the workpapers. The examiner must document all tasks that the taxpayer performs within the activity.

Some taxpayers will attempt to downplay any pleasurable aspects of the activity. Many taxpayers will express a passion for their activity. A skilled examiner will be able to draw this passion from the taxpayer through conversation. The courts do not mandate that taxpayers cannot enjoy the method by which they derive their income. Many taxpayers resist the phraseology of “hobby loss” in reference to IRC § 183. Examiners may wish to refrain from that terminology and refer to the actual title “Activity Not Engaged in for Profit.”

Summary of Factor 9

The examiner needs to address the pleasurable and recreational aspects of the activity. By this point in the examination, the taxpayer is aware of the direction that the exam is going. The taxpayer knows about the nine relevant factors. A taxpayer with a savvy representative has been advised to downplay the pleasurable aspects and emphasize the hard work of the activity. Skilled listening will help the examiner to document and sort the details regarding this relevant factor.

Appendix B - Suggested Interview Questions for Each of 9 Relevant Factors

The following are suggested possible interview questions for each of the nine factors contained in Treas. Regs. §1.183-2(b)(1) through (9) which may be used by examiners to establish if an activity is or is not for profit. Other factors not listed may also need to be considered.

These questions should not be considered all-inclusive. The interview should be tailored to each specific taxpayer. The questions should be asked of the taxpayer in an interview and not be given to the taxpayer and/or authorized representative to complete.

1.183-2(b)(1) Manner in which the taxpayer carries on the activity

- Background and general description of the business.
  - When did the taxpayer first include (first Schedule C, F. 1120S, 1065, etc.) this business for tax purposes?
  - General industry, what specialized niche?
  - Where is business conducted?
  - What geographical area?
  - Specific demographic target population?
  - Is the business seasonal?
  - Did the taxpayer have a business plan?
  - Was the plan followed?
  - How did the taxpayer propose to compete with similar businesses?
  - When/how did the idea for the business activity originate?
  - Was a business plan written-up?
  - What were the financial requirements to start the business?
  - How were the funds obtained?
  - Bank loans, investors, personal savings, family, etc.?
  - What documentation is available?
  - How is the business currently being financed?
  - What financial risks are involved in this type of business?
  - Is any type of business insurance carried?
  - Are policies in the business name?
  - Did the taxpayer carry on any of these same policies prior to starting the business?
  - Did the taxpayer stand to lose or have expenses beyond what he normally incurs?
  - Does the activity involve multiple undertakings; and if so, what is the organizational and economic interrelationship between them?
  - Does taxpayer have a license to operate?
  - Is the activity in an area zoned for business?
  - Is the taxpayer’s telephone number listed in the white/yellow pages?
  - Does the taxpayer have an internet site?
  - How do customers find out about the business?
  - Are signs posted?
  - Is the activity still being conducted?

    - Are any relatives employed in the business?
    - If relatives are employed, how is wage determined?
- How are the business records maintained?
    - Describe the system for recording income and expenses.
    - Are budgets prepared?
    - When and by whom are expenses recorded?
    - What types of journals are maintained?
    - Are books on cash or accrual?
    - Are books and records accurate and complete? If not, why not?
    - Are books comparable to types of books kept by others in same activity?
    - Is a computer used? What software program is used?
    - Are financial statements prepared?
    - How often and by whom?
    - Is an accountant or bookkeeper involved?
    - What do they do and how often?
    - Have they given any advice on the business?
    - Are separate bank account(s) used for the business?
    - If no, why not?
    - Are ATM (cash or credit/debit) cards used on the account(s)?
    - Are there transfers between business and personal accounts?
    - If yes, how are they kept track of in the business books?
    - Are the bank statements used to determine business and expenses for the year?
- What efforts are made in terms of attracting customers and securing suppliers or products necessary for the business?
    - What advertising and promotion activity did the taxpayer perform to gain clients/buyers?
    - What other relationship did the taxpayer have with his clients/buyers?
    - What other relationship did the taxpayer have with his suppliers?
    - What other relationship did the taxpayer have with his employees?
    - What forms of advertising have been used? How often? How much?
    - How effective was the advertising? Have ineffective methods been discontinued?
    - Have steps been taken to improve profitability?
    - Any changes in operating methods? What changes?
- When is a profit expected?
    - What type of profit expectations are there?
    - What is maximum profit expected?
    - When will profit occur?
    - Is it reasonable to expect any profit will result?
    - How many “widgets” must be sold in order to obtain a profit?

1.183-2(b)(2) The expertise of the taxpayer or his advisors

Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those are experts therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices.

- What background information was gathered about this type of activity prior to beginning the business?
    - Has the taxpayer ever been employed in this area before?
    - When, where, for whom, how long, what experience specifically pertains to this activity?
- Does the taxpayer have any education which is relevant?
    - Educational institution?
    - Degree, classes, how does it apply to this business or how did it prepare the taxpayer in any way to enter this field of business?
    - Does the education relate to any other business or employment activities?
- Did the taxpayer rely on the advice of others in starting or developing the business?
    - Did the taxpayer consult with experts?
    - What are the credentials of others in starting or developing the business?
    - What experience, education, degrees, business success do they possess which qualify them to advice the taxpayer?
    - How did the taxpayer decide to rely on the person(s) advice?
    - Was there any kind of previous personal, family or business relationship with the advisor?
- Did the taxpayer prepare for the activity by conducting research or an extensive study of its accepted business, economic, and scientific practices?
    - What types of journals, publications, or other reference material did the taxpayer study in preparation to enter this business?
    - What did the taxpayer learn which entered into the decision to engage in this business activity?
    - What professional publications does the taxpayer now subscribe to and what specific benefit does the taxpayer derive?
- What other life experiences does the taxpayer have which would have prepared the taxpayer to engage in this type of activity?
- What related organizations does the taxpayer belong to? How long?

1.183-2(b)(3) The time and effort expended by the taxpayer in carrying on the activity

The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreation aspects, may indicate an intention to derive profit.

Note – This factor may be given greater weight (in taxpayer's favor) if there are no substantial personal or recreational aspects present.

- For the taxpayer personally, is this a full-time or part- time activity?
    - How many hours per week? per month? per year? per season? are spent on this activity?
    - What tasks does taxpayer perform?
    - Is this more or less time than others in the same line of work devote?
    - Did the taxpayer have to give up or reduce the time devoted to a different job or occupation?
    - If personal time was given up, what did the taxpayer previously do with that time?

    - If time is not devoted to the activity, did the taxpayer employ competent and qualified persons to carry on the activity?
- Who is involved with the day to day business operations?
    - Does the activity have employees?
    - How many?
    - What are their duties and who does what?
    - What are their hours? Full-time or part-time? Salaries?
    - Are employment tax returns filed?
    - Are any relatives involved with the business in any respect?
    - Are information returns prepared?
    - What are the taxpayer's own duties and responsibilities with respect to the business?
    - If someone other than the taxpayer is running the business for them, what qualifications and relevant business background do they have?
    - What decisions do they make?

1.183-2(b)(4) Expectation that assets used in activity may appreciate in value

The term "profit" encompasses appreciation in the value of assets used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that even if no profit when appreciation in the value of the land used in the activity realized since income from the activity together with appreciation of land will exceed expenses of operation.

- List assets used in the activity.
    - Were the assets held prior to starting the business?
    - Was depreciation previously taken as a deduction?
    - What was the prior use?
    - How and when were the assets acquired (verify taxpayer's basis)?
    - Are any assets used personally?
    - How much is each asset worth today?
    - Has anyone ever offered to buy any of the assets?
    - Is it likely the assets will appreciate in value?
    - Why does the taxpayer expect the appreciation to occur?
    - At what rate are assets expected to appreciate?
    - Over what period of time (how many years)?
    - What are the taxpayer's plans for the appreciated asset(s)?
    - At what point does the taxpayer intend to realize the inherent gain for tax purposes?
    - Will the gain on appreciated assets offset operating losses – to the extent that the overall net result on the business is a profit?

1.183-2(b)(5) The success of the taxpayer in other similar or dissimilar activities

The fact that the taxpayer has engaged in similar activities in the past and converted these from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

- What other activities has the taxpayer had previous success?
    - Which, if any, were converted from unprofitable into profitable ventures (describe how the taxpayer was involved in this process – what did the taxpayer do to convert it)?
    - What happened to that prior business?
    - Ultimately, were the business(s) profitable on an overall net basis?

1.183-2(b)(6) The taxpayer's history of income or losses with respect to the activity

A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status, such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances, which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course by strong evidence that the activity is engaged in for profit.

The examiner should prepare a comparative schedule of income and losses (expenses) since inception of the business through the present. **Appendix D** contains a sample year by year analysis of income and expenses.

Year	**XXXX12**	**XXXX12**	**XXXX12**	**XXXX12**	**XXXX12**
Gross Income					
Expenses (Other than Depreciation)					
Depreciation					
(Losses) or Gains					

- Is there a trend toward profitability?
- Are there any profitable years?
- Are there consistent losses?
- Do the losses increase from year to year?
- Have losses continued beyond what would ordinarily be considered customary?
- What is the taxpayer's explanation for continuing with an unprofitable activity?
- Did the taxpayer change operating methods, adopt new techniques, or abandon nonprofitable methods in a manner consistent with intent to improve profitability.
- Why did the taxpayer continue the operation if it continued to lose money?
- Were there unforeseen circumstances?
- Were they beyond the control of the taxpayer?
- What happened and when?
- How did this change the taxpayer's business plans and what action was taken to deal with the unforeseen circumstances?

1.183-2(b)(7) The amount of occasional profits, if any, which are earned

The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinary sufficient to indicate the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

- What profits have been earned in any year?
  - Is this a highly speculative business?
  - Is there any change that the activity could generate a substantial profit in the future which would recover prior losses and the taxpayer's investment?
- What amount of an investment has the taxpayer made in the business?
  - Is this amount significant in relation to the taxpayer's net worth?
  - What percent of the taxpayer's net worth has been invested in this venture (obtain financial statements or other evidence of taxpayer's net worth)?

1.183-2(b)(8) The financial status of the taxpayer

The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that the activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.

Note – When substantial tax benefits are being derived, greater weight may be given to the possibility the activity is not for profit, especially if personal or recreational elements are present.

- Does the taxpayer have substantial income or capital (investments, etc.) from other sources (list types, sources and amounts)?
  - What tax benefit does the taxpayer receive from the losses on the activity?
  - Are there other economic reasons for the taxpayer to be engaged in the activity? E.g. reduced property taxes for farmland, low interest loans, or federal grants?
  - Can the taxpayer otherwise afford (based on taxpayer's net worth) to continue with the activity regardless of continued losses?

1.183-2(b)(9) Elements of personal pleasure or recreation

The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, 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. 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.

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

- Was the taxpayer involved or interested in this, or a related activity, prior to establishing it as a business for tax purposes?
    - Are elements of fun or recreation generally associated with it by either the taxpayer, members of the taxpayer's family or by the taxpayer's friends?
    - If there are any personal benefits (other than that of succeeding in the business) to being in this business, are they substantial?
    - If the taxpayer previously engaged in the activity for other than business purposes, what currently distinguishes the activity as a business over what was done before?
    - Would the taxpayer continue the activity even if he or she never made a profit?