

taxpayer is employed as a skilled machine operator in a nearby factory, for which he is paid approximately \$8,500 per year. The farm has not been profitable for the past 15 years because of rising costs of operating farms in general, and because of the decline in the price of the produce of this farm in particular. The taxpayer consults the local agent of the State agricultural service from time to time, and the suggestions of the agent have generally been followed. The manner in which the farm is operated by the taxpayer is substantially similar to the manner in which farms of similar size, and which grow similar crops in the area, are operated. Many of these other farms do not make profits. The taxpayer does much of the required labor around the farm himself, such as fixing fences, planting crops, etc. The activity of farming could be found, based on all the facts and circumstances, to be engaged in by the taxpayer for profit.

Example 5. A, an independent oil and gas operator, frequently engages in the activity of searching for oil on undeveloped and unexplored land which is not near proven fields. He does so in a manner substantially similar to that of others who engage in the same activity. The chances, based on the experience of A and others who engaged in this activity, are strong that A will not find a commercially profitable oil deposit when he drills on land not established geologically to be proven oil bearing land. However, on the rare occasions that these activities do result in discovering a well, the operator generally realizes a very large return from such activity. Thus, there is a small chance that A will make a large profit from his soil exploration activity. Under these circumstances, A is engaged in the activity of oil drilling for profit.

Example 6. C, a chemist, is employed by a large chemical company and is engaged in a wide variety of basic research projects for his employer. Although he does no work for his employer with respect to the development of new plastics, he has always been interested in such development and has outfitted a workshop in his home at his own expense which he uses to experiment in the field. He has patented several developments at his own expense but as yet has realized no income from his inventions or from such patents. C conducts his research on a regular, systematic basis, incurs fees to secure consultation on his projects from time to time, and makes extensive efforts to "market" his developments. C has devoted substantial time and expense in an effort to develop a plastic sufficiently hard, durable, and malleable that it could be used in lieu of sheet steel in many major applications, such as automobile bodies. Although there may be only a small chance that C will invent new plastics, the return from any such development would be so large that it induces C to incur the costs of his experimental work. C

is sufficiently qualified by his background that there is some reasonable basis for his experimental activities. C's experimental work does not involve substantial personal or recreational aspects and is conducted in an effort to find practical applications for his work. Under these circumstances, C may be found to be engaged in the experimental activities for profit.

[T.D. 7198, 37 FR 13683, July 13, 1972]

§ 1.183-3 Election to postpone determination with respect to the presumption described in section 183(d). [Reserved]

§ 1.183-4 Taxable years affected.

The provisions of section 183 and the regulations thereunder shall apply only with respect to taxable years beginning after December 31, 1969. For provisions applicable to prior taxable years, see section 270 and § 1.270-1.

[T.D. 7198, 37 FR 13685, July 13, 1972]

§ 1.186-1 Recoveries of damages for antitrust violations, etc.

(a) *Allowance of deduction.* Under section 186, when a compensatory amount which is included in gross income is received or accrued during a taxable year for a compensable injury, a deduction is allowed in an amount equal to the lesser of (1) such compensatory amount, or (2) the unrecovered losses sustained as a result of such compensable injury.

(b) *Compensable injury*—(1) *In general.* For purposes of this section, the term *compensable injury* means any of the injuries described in subparagraph (2), (3), or (4) of this paragraph.

(2) *Patent infringement.* An injury sustained as a result of an infringement of a patent issued by the United States (whether or not issued to the taxpayer or another person or persons) constitutes a compensable injury. The term *patent issued by the United States* means any patent issued or granted by the United States under the authority of the Commissioner of Patents pursuant to 35 U.S.C. 153.

(3) *Breach of contract or of fiduciary duty or relationship.* An injury sustained as a result of a breach of contract (including an injury sustained by a third party beneficiary) or a breach of fiduciary duty or relationship constitutes a compensable injury.

(4) *Injury suffered under certain anti-trust law violations.* An injury sustained in business, or to property, by reason of any conduct forbidden in the antitrust laws for which a civil action may be brought under section 4 of the Act of October 15, 1914 (15 U.S.C. 15), commonly known as the Clayton Act, constitutes a compensable injury.

(c) *Compensatory amount*—(1) *In general.* For purposes of this section, the term, *compensatory amount* means any amount received or accrued during the taxable year as damages as a result of an award in, or in settlement of, a civil action for recovery for a compensable injury, reduced by any amounts paid or incurred in the taxable year in securing such award or settlement. The term *compensatory amount* includes only amounts compensating for actual economic injury. Thus, additional amounts representing punitive, exemplary, or treble damages are not included within the term. Where, for example, a taxpayer recovers treble damages under section 4 of the Clayton Act, only one-third of the recovery representing economic injury constitutes a compensatory amount. In the absence of any indication to the contrary, amounts received in settlement of an action shall be deemed to be a recovery for an actual economic injury except to the extent such settlement amounts exceed actual damages claimed by the taxpayer in such action.

(2) *Interest on a compensatory amount.* Interest attributable to a compensatory amount shall not be included within the term *compensatory amount*.

(3) *Settlement of a civil action for damages*—(i) *Necessity for an action.* The term *compensatory amount* does not include an amount received or accrued in settlement of a claim for a compensable injury if the amount is received or accrued prior to institution of an action. An action shall be considered as instituted upon completion of service of process, in accordance with the laws and rules of the court in which the action has been commenced or to which the action has been removed, upon all defendants who pay or incur an obligation to pay a compensatory amount.

(ii) *Specifications of the parties.* If an action for a compensable injury is settled, the specifications of the parties

will generally determine compensatory amounts unless such specifications are not reasonably supported by the facts and circumstances of the case. For example, the parties may provide that the sum of \$1,000 represents actual damages sustained as the result of antitrust violations and that the total amount of the settlement after the tripling of damages is \$3,000. In such case, only the sum of \$1,000 would be a compensatory amount. In the absence of specifications of the parties, the complaint filed by the taxpayer may be considered in determining what portion of the amount of the settlement is a compensatory amount.

(4) *Amounts paid or incurred in securing the award or settlement.* For purposes of this section, the term *amounts paid or incurred in the taxable year in securing such award or settlement* shall include legal expenses such as attorney's fees, witness fees, accountant fees, and court costs. Expenses incurred in securing a recovery of both a compensatory amount and other amounts from the same action shall be allocated among such amounts in the ratio each of such amounts bears to the total recovery. For instance, where a taxpayer incurs attorney's fees and other expenses of \$3,000 in recovering \$10,000 as a compensatory amount, \$5,000 as a return of capital, and \$25,000 as punitive damages from the same action, the taxpayer shall allocate \$750 of the expenses to the compensatory amount ($10,000/40,000 \times 3,000$), \$375 to the return of capital ($5,000/40,000 \times 3,000$), and \$1,875 to the punitive damages ($25,000/40,000 \times 3,000$).

(d) *Unrecovered losses*—(1) *In general.* For purposes of this section, the term *unrecovered losses sustained as a result of such compensable injury* means the sum of the amounts of the net operating losses for each taxable year in whole or in part within the injury period, to the extent that such net operating losses are attributable to such compensable injury, reduced by (i) the sum of any amounts of such net operating losses which were allowed as a net operating loss carryback or carryover for any prior taxable year under the provisions of section 172, and (ii) the sum of any amounts allowed as deductions under section 186 (a) and this section for all

prior taxable years with respect to the same compensable injury. Accordingly, a deduction is permitted under section 186(a) and this section with respect to net operating losses whether or not the period for carryover under section 172 has expired.

(2) *Injury period.* For purposes of this section, the term *injury period* means (i) with respect to an infringement of a patent, the period during which the infringement of the patent continued, (ii) with respect to a breach of contract or breach of fiduciary duty or relationship, the period during which amounts would have been received or accrued but for such breach of contract or breach of fiduciary duty or relationship, or (iii) with respect to injuries sustained by reason of a violation of section 4 of the Clayton Act, the period during which such injuries were sustained. The injury period will be determined on the basis of the facts and circumstances of the taxpayer's situation. The injury period may include a period before and after the period covered by the civil action instituted.

(3) *Net operating losses attributable to compensable injuries.* A net operating loss for any taxable year shall be treated as attributable (whether actually attributable or not) to a compensable injury to the extent the compensable injury is sustained during the taxable year. For purposes of determining the extent of the compensable injury sustained during a taxable year, a judgment for a compensable injury apportioning the amount of the recovery (not reduced by any amounts paid or incurred in securing such recovery) to specific taxable years within the injury period will be conclusive. If a judgment for a compensable injury does not apportion the amount of the recovery to specific taxable years within the injury period, the amount of the recovery will be prorated among the years within the injury period in the proportion that the net operating loss sustained in each of such years bear to the total net operating losses sustained for all such years. If an action is settled, the specifications of the parties will generally determine the apportionment of the amount of the recovery unless such specifications are not reasonably supported by the facts and circumstances

of the case. In the absence of specifications of the parties, the amount of the recovery will be prorated among the years within the injury period in the proportion that the net operating loss sustained in each of such years bears to the total net operating losses sustained for all such years.

(4) *Application of losses attributable to a compensable injury.* If only a portion of a net operating loss for any taxable year is attributable to a compensable injury, such portion shall (in applying section 172 for purposes of this section) be considered to be a separate net operating loss for such year to be applied after the other portion of such net operating loss. If, for example, in the year of the compensable injury the net operating loss was \$1,000 and the amount of the compensable injury was \$600, the amount of \$400 not attributable to the compensable injury would be used first to offset profits in the carryover or carryback periods as prescribed by section 172. After the amount not attributable to the compensable injury is used to offset profits in other years, then the amount attributable to the compensable injury will be applied against profits in the carryover or carryback periods.

(e) *Effect on net operating loss carryovers—(1) In general.* Under section 186 (e) if for the taxable year in which a compensatory amount is received or accrued any portion of the net operating loss carryovers to such year is attributable to the compensable injury for which such amount is received or accrued, such portion of the net operating loss carryovers must be reduced by the excess, if any, of (i) the amount computed under section 186(e)(1) with respect to such compensatory amount, over (ii) the amount computed under section 186(e)(2) with respect to such compensable injury.

(2) *Amount computed under section 186(e)(1).* The amount computed under section 186(e)(1) is equal to the deduction allowed under section 186(a) with respect to the compensatory amount received or accrued for the taxable year.

(3) *Amount computed under section 186(e)(2).* The amount computed under section 186(e)(2) is equal to that portion of the unrecovered losses sustained as a

result of the compensable injury with respect to which, as of the beginning of the taxable year, the period for carryover under section 172 has expired without benefit to the taxpayer, but only to the extent that such portion of the unrecovered losses did not reduce an amount computed under section 186(e)(1) for any prior taxable year.

(4) *Increase in income under section 172(b)(2)*. If there is a reduction for any taxable year under subparagraph (1) of this paragraph in the portion of the net operating loss carryovers to such year attributable to a compensable injury, then, solely for purposes of determining the amount of such portion which may be carried to subsequent taxable years, the income of such taxable year, as computed under section 172(b)(2), shall be increased by the amount of the reduction computed under subparagraph (1) of this paragraph, for such year.

(f) *Illustration*. The provisions of section 186 and this section may be illustrated by the following example:

Example. (i) As of the beginning of his taxable year 1969, taxpayer A has a net operating loss carryover from his taxable year 1966 of \$550 of which \$250 is attributable to a compensable injury. In addition, he has a net operating loss attributable to the compensable injury of \$150 with respect to which the period for carryover under section 172 has expired without benefit to the taxpayer. In 1969, he receives a \$100 compensatory amount with respect to that injury and he has \$75 in other income. Thus, A has gross income of \$175 and he is entitled to a \$100 deduction (the compensatory amount received) under section 186(a) and this section since this amount is less than the unrecovered losses sustained as a result of the compensable injury ($\$250 + \$150 = \$400$). No portion of the net operating loss carryover to the current taxable year attributable to the compensable injury is reduced under section 186(e) since the amount determined under section 186(e)(1) (\$100) does not exceed the amount determined under section 186(e)(2) (\$150). Therefore, A applies a net operating loss carryover of \$550 against his remaining income of \$75 and retains a net operating loss carryover of \$475 to following years of which amount \$250 remains attributable to the compensable injury. In addition, he retains \$50 of net operating losses attributable to the compensable injury with respect to which the period for carryover under section 172 has expired without benefit to the taxpayer.

(ii) In 1970, A receives a \$200 compensatory amount with respect to the same compensable injury and has \$75 of other income. Thus, A has gross income of \$275 and he is entitled to a \$200 deduction (the compensatory amount received) under section 186(a) and this section since this amount is less than the remaining unrecovered loss sustained as a result of the compensable injury ($\$250 + \$50 = \$300$). The net operating loss carryover to the current taxable year of \$250 attributable to the compensable injury is reduced under section 186(e) by \$150, which is the excess of the amount determined under section 186(e)(1) (\$200) over the amount determined under section 186(e)(2) (\$50). Therefore, A applies net operating loss carryovers of \$325 (\$225 not attributable to the compensable injury, +\$100 attributable to such injury) against his remaining income of \$75. A retains net operating loss carryovers of \$250 for following years, of which amount \$100 is attributable to the compensable injury. A has used all of his net operating losses attributable to the compensable injury with respect to which the period for carryover under section 172 has expired without benefit to the taxpayer.

(iii) In 1971, A receives a \$200 compensatory amount with respect to the same compensable injury and has \$75 of other income. Thus, A has gross income of \$275 and he is entitled to a \$100 deduction (the amount of unrecovered losses) under section 186(a) and this section since this amount is less than the compensatory amount received (\$200). The net operating loss carryover to the current taxable year of \$100 attributable to the compensable injury is reduced under section 186(e) by \$100, which is the excess of the amount determined under section 186(e)(1) (\$100) over the amount determined under section 186(e)(2) (\$0). Therefore, A applies net operating loss carryovers of \$150 against his remaining income of \$175 (\$100 compensatory amount plus \$75 other income) which leaves \$25 taxable income. No net operating loss carryover remains for following years.

(g) *Effective date*. The provisions of this section are applicable as to compensatory amounts received or accrued in taxable years beginning after December 31, 1968, even though the compensable injury was sustained in taxable years beginning before such date.

[T.D. 7220, 37 FR 24744, Nov. 21, 1972]

§ 1.187-1 Amortization of certain coal mine safety equipment.

(a) *Allowance of deduction*—(1) *In general*. Under section 187(a), every person, at his election, shall be entitled to a