

Internal Revenue Service, Treasury

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the house for his own vacation during the remaining month of the recreational season. In 1971, A leases the house for 2 months for \$1,000 per month and actually uses the house for his own vacation during the other month of the recreational season. For 1971, the expenses attributable to the house are \$1,200 interest, \$600 real estate taxes, \$600 maintenance, \$300 utilities, and \$1,200 which would have been allowed as depreciation had the activity been engaged in for profit. Under these facts and circumstances, A is engaged in a single activity, holding the beach house primarily for personal purposes, which is an "activity not engaged in for profit" within the meaning of section 183(c). See paragraph (b)(9) of § 1.183-2.

(ii) Since the \$1,200 of interest and the \$600 of real estate taxes are specifically allowable as deductions under sections 163 and 164(a) without regard to whether the beach house activity is engaged in for profit, no allocation of these expenses between the uses of the beach house is necessary. However, since section 262 specifically disallows personal, living, and family expenses as deductions, the maintenance and utilities expenses and the depreciation from the activity must be allocated between the rental use and the personal use of the beach house. Under the particular facts and circumstances, $\frac{2}{3}$ (2 months of rental use over 3 months of total use) of each of these expenses are allocated to the rental use, and $\frac{1}{3}$ (1 month of personal use over 3 months of total use) of each of these expenses are allocated to the personal use as follows:

	Rental use 2/3— expenses al- locable to section 183(b)(2)	Personal use 1/3— expenses al- locable to section 262
Maintenance expense \$600 ..	\$400	\$200
Utilities expense \$300	200	100
Depreciation \$1,200	800	400
Total	1,400	700

The \$700 of expenses and depreciation allocated to the personal use of the beach house are disallowed as a deduction under section 262. In addition, the allowability of each of the expenses and the depreciation allocated to section 183(b)(2) is determined under paragraph (b)(1) (ii) and (iii) of this section. Thus, the maximum amount allowable as a deduction under section 183(b)(2) is \$200 (\$2,000 gross income from activity, less \$1,800 deductions under section 183(b)(1)). Since the amounts described in section 183(b)(2) (\$1,400) exceed the maximum amount allowable (\$200), and since the amounts described in paragraph (b)(1)(ii) of this section (\$600) exceed such maximum amount allowable (\$200), none of the depreciation (an amount de-

scribed in paragraph (b)(1)(iii) of this section) is allowable as a deduction.

(e) *Gross income from activity not engaged in for profit defined.* For purposes of section 183 and the regulations thereunder, gross income derived from an activity not engaged in for profit includes the total of all gains from the sale, exchange, or other disposition of property, and all other gross receipts derived from such activity. Such gross income shall include, for instance, capital gains, and rents received for the use of property which is held in connection with the activity. The taxpayer may determine gross income from any activity by subtracting the cost of goods sold from the gross receipts so long as he consistently does so and follows generally accepted methods of accounting in determining such gross income.

(f) *Rule for electing small business corporations.* Section 183 and this section shall be applied at the corporate level in determining the allowable deductions of an electing small business corporation.

[T.D. 7198, 37 FR 13680, July 13, 1972]

§ 1.183-2 Activity not engaged in for profit defined.

(a) *In general.* For purposes of section 183 and the regulations thereunder, the term *activity not engaged in for profit* means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212. Deductions are allowable under section 162 for expenses of carrying on activities which constitute a trade or business of the taxpayer and under section 212 for expenses incurred in connection with activities engaged in for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Except as provided in section 183 and § 1.183-1, no deductions are allowable for expenses incurred in connection with activities which are not engaged in for profit. Thus, for example, deductions are not allowable under section 162 or 212 for activities which are carried on primarily as a sport, hobby, or for recreation. The determination whether an activity is engaged in for

profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit. In determining whether such an objective exists, it may be sufficient that there is a small chance of making a large profit. Thus it may be found that an investor in a wildcat oil well who incurs very substantial expenditures in the venture for profit even though the expectation of a profit might be considered unreasonable. In determining whether an activity is engaged in for profit, greater weight is given to objective facts than to the taxpayer's mere statement of his intent.

(b) *Relevant factors.* In determining whether an activity is engaged in for profit, all facts and circumstances with respect to the activity are to be taken into account. No one factor is determinative in making this determination. In addition, it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa. Among the factors which should normally be taken into account are the following:

(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.

(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.

(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.

(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 for definition of an activity in this connection.

(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.

(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.

(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.

(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.

(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.

(c) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. The taxpayer inherited a farm from her husband in an area which was becoming largely residential, and is now nearly all so. The farm had never made a profit before the taxpayer inherited it, and the farm has since had substantial losses in each year. The decedent from whom the taxpayer inherited the farm was a stockbroker, and he also left the taxpayer substantial stock holdings which yield large income from dividends. The taxpayer lives on an area of the farm which is set aside exclusively for living purposes. A farm manager is employed to operate the farm, but modern methods are not used in operating the farm. The taxpayer was born and raised on a farm, and expresses a strong preference for living on a farm. The taxpayer's activity of farming, based on all

the facts and circumstances, could be found not to be engaged in for profit.

Example 2. The taxpayer is a wealthy individual who is greatly interested in philosophy. During the past 30 years he has written and published at his own expense several pamphlets, and he has engaged in extensive lecturing activity, advocating and disseminating his ideas. He has made a profit from these activities in only occasional years, and the profits in those years were small in relation to the amounts of the losses in all other years. The taxpayer has very sizable income from securities (dividends and capital gains) which constitutes the principal source of his livelihood. The activity of lecturing, publishing pamphlets, and disseminating his ideas is not an activity engaged in by the taxpayer for profit.

Example 3. The taxpayer, very successful in the business of retailing soft drinks, raises dogs and horses. He began raising a particular breed of dogs many years ago in the belief that the breed was in danger of declining, and he has raised and sold the dogs in each year since. The taxpayer recently began raising and racing thoroughbred horses. The losses from the taxpayer's dog and horse activities have increased in magnitude over the years, and he has not made a profit on these operations during any of the last 15 years. The taxpayer generally sells the dogs only to friends, does not advertise the dogs for sale, and shows the dogs only infrequently. The taxpayer races his horses only at the "prestige" tracks at which he combines his racing activities with social and recreational activities. The horse and dog operations are conducted at a large residential property on which the taxpayer also lives, which includes substantial living quarters and attractive recreational facilities for the taxpayer and his family. Since (i) the activity of raising dogs and horses and racing the horses is of a sporting and recreational nature, (ii) the taxpayer has substantial income from his business activities of retailing soft drinks, (iii) the horse and dog operations are not conducted in a businesslike manner, and (iv) such operations have a continuous record of losses, it could be determined that the horse and dog activities of the taxpayer are not engaged in for profit.

Example 4. The taxpayer inherited a farm of 65 acres from his parents when they died 6 years ago. The taxpayer moved to the farm from his house in a small nearby town, and he operates it in the same manner as his parents operated the farm before they died. The 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

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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 antitrust 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