T.C. Memo. 1983-520

To deduct losses from an activity, taxpayers must demonstrate a bona fide profit motive, even if profit expectation is not necessarily reasonable; this intent is evaluated based on a totality of factors, not any single factor.

Summary

Truett and Barbara Allen deducted losses from their Vermont lodge, claiming it was a for-profit rental activity. The IRS disallowed the deductions, arguing it was a hobby not engaged in for profit under Section 183. The Tax Court examined factors like businesslike operation, expertise, taxpayer effort, history of losses, and personal pleasure. Despite consistent losses, the court found the Allens operated the lodge with a genuine profit motive, evidenced by their businesslike approach, efforts to improve profitability, and lack of personal use. The court allowed the deductions, emphasizing that unforeseen circumstances and market downturns can explain losses in a for-profit venture.

Facts

Truett Allen purchased land in Vermont in 1964, believing a ski lodge would be a viable investment due to growing ski industry. He built a lodge himself and began renting it in December 1965. The Allens advertised extensively, used real estate agents, and kept detailed records. They experimented with different rental strategies: family groups, inn operation, full-season rentals, and short-term leases. Despite efforts, the lodge consistently generated losses due to increased competition, poor snow conditions, and the 1970s gasoline shortage. The Allens never used the lodge for personal purposes, only for maintenance and business tasks. Mr. Allen was a bank executive, and Mrs. Allen worked in advertising; their primary income was from these sources.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in the Allens' federal income taxes for 1971 and 1972, disallowing deductions related to the lodge operation. The Allens petitioned the Tax Court, contesting the Commissioner's determination that the lodge activity was not engaged in for profit under Section 183 of the Internal Revenue Code.

Issue(s)

1. Whether the petitioners' operation of their lodge constituted an "activity not engaged in for profit" under Section 183(a) of the Internal Revenue Code, thus disallowing deductions beyond the extent of gross income from the activity?

Holding

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1. Yes, for the petitioners. The Tax Court held that despite continuous losses, the Allens operated the lodge with a bona fide intention to make a profit, and therefore, the lodge activity was not considered an "activity not engaged in for profit" under Section 183(a). The losses were fully deductible.

Court's Reasoning

The court applied the standard that to deduct expenses under Sections 162 or 212, the activity must be undertaken with the "predominant purpose and intention of making a profit." While a reasonable expectation of profit is not required, a "good-faith expectation" is necessary. The court considered factors from Treasury Regulation §1.183-2(b) to assess profit motive, including:

- **Manner of Operation:** The Allens operated in a businesslike manner, keeping records, advertising, and using agents.
- **Expertise:** Mr. Allen's business background was relevant, though not determinative against profit motive.
- **Time and Effort:** The Allens devoted significant effort to managing and maintaining the lodge.
- **Asset Appreciation:** The lodge's appreciated value indicated potential long-term profit.
- **History of Losses:** While losses existed, they were explained by external factors like market saturation, weather, and gasoline shortages, which are considered "unforeseen or fortuitous circumstances…beyond the control of the taxpayer" under regulations. The court quoted Treas. Reg. §1.183-2(b)(6).
- **Changes in Methods:** The Allens' experimentation with different rental models (inn, seasonal rentals) demonstrated efforts to improve profitability. The court quoted Treas. Reg. §1.183-2(b)(1): "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."
- **Lack of Personal Pleasure:** The Allens never used the lodge for personal recreation, reinforcing business purpose.

The court concluded, "based on all of the facts and circumstances in this case, we are convinced that the petitioners intended to derive a profit from renting their lodge."

Practical Implications

Allen v. Commissioner is frequently cited in hobby loss cases, illustrating that consistent losses alone do not automatically disqualify an activity as for-profit. It emphasizes a holistic, multi-factor approach to determining profit motive. Attorneys advising clients on deductibility of losses from activities must document businesslike operations, marketing efforts, adaptation to changing market conditions, and minimal personal use. The case highlights that external economic factors and

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unforeseen events can explain losses in a legitimate business venture. It reinforces that taxpayers need not demonstrate a *reasonable* expectation of profit, but a genuine, good-faith *intent* to profit, supported by objective factors. Later cases often distinguish *Allen* based on weaker evidence of businesslike activity or stronger indications of personal pleasure derived from the activity.

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