Engdahl v. Commissioner, 72 T. C. 659 (1979)

The court established criteria for determining whether an activity is engaged in for profit under IRC Section 183.

Summary

Theodore and Adeline Engdahl operated a horse-breeding venture intending to supplement retirement income. Despite continuous losses, the U. S. Tax Court held that the activity was engaged in for profit under IRC Section 183. The court considered the Engdahls' business-like conduct, reliance on expert advice, significant time investment, and lack of personal pleasure from the activity as evidence of a profit motive, despite the absence of profit over several years.

Facts

Theodore N. and Adeline M. Engdahl operated an American saddle-bred horse-breeding operation starting in 1964. They purchased a ranch in 1967 for this purpose and spent significant time and effort on the operation. Despite their efforts, the venture incurred losses every year from 1964 to 1975. The Engdahls had other income from Dr. Engdahl's orthodontic practice against which they claimed the losses. They consulted experts, maintained detailed records, and made operational changes in an attempt to improve profitability.

Procedural History

The Commissioner of Internal Revenue disallowed the Engdahls' claimed losses and investment credits for 1971, 1972, and 1973, arguing the horse-breeding operation was a hobby under IRC Section 183. The Engdahls petitioned the U. S. Tax Court, which ruled in their favor, allowing the deductions and credits based on a finding of profit motive.

Issue(s)

1. Whether the Engdahls' horse-breeding operation was an activity engaged in for profit under IRC Section 183.

Holding

1. Yes, because the court found that the Engdahls conducted their horse-breeding operation with a bona fide intent to derive a profit, evidenced by their business-like conduct, reliance on expert advice, significant time investment, and lack of personal pleasure from the activity.

Court's Reasoning

The court applied the factors listed in Treasury Regulation Section 1. 183-2(b) to

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determine the Engdahls' profit motive. They emphasized the Engdahls' business-like manner of operation, including detailed record-keeping, advertising efforts, and operational changes aimed at improving profitability. The court also considered the Engdahls' reliance on expert advice, their substantial time investment, and the expectation of asset appreciation. Despite continuous losses, the court found these factors indicative of a profit motive, especially since the losses were due to unforeseen circumstances and the operation was still in its start-up phase. The court rejected the Commissioner's arguments about the Engdahls' other income and the recreational nature of the activity, finding no substantial personal pleasure derived from the operation.

Practical Implications

This decision provides guidance on determining profit motive under IRC Section 183, emphasizing the importance of business-like conduct, reliance on expert advice, and the absence of personal pleasure in the activity. It informs legal practice in hobby loss cases by highlighting the relevance of objective facts over mere statements of intent. Practitioners should advise clients to maintain detailed records, seek professional advice, and make operational changes to demonstrate a profit motive. The decision also impacts how similar cases are analyzed, focusing on the totality of circumstances rather than any single factor. Subsequent cases like *Allen v. Commissioner* have applied and distinguished this ruling, further refining the application of Section 183.

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