The Supreme Court Gambles on the Definition of Trade or Business: Commissioner v. Groetzinger

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THE SUPREME COURT GAMBLES ON THE DEFINITION OF TRADE OR BUSINESS: COMMISSIONER v. GROETZINGER

Under sections 162(a)\(^1\) and 62(a)(1)\(^2\) of the Internal Revenue Code ("Code"), a taxpayer's adjusted gross income is computed by deducting from his gross income all ordinary and necessary expenses incurred while carrying on a trade or business.\(^3\) The term

\(^1\) Tax Reform Act of 1986, Pub. L. No. 99-514, § 162(a), 100 Stat. 2085 (codified as amended at 26 U.S.C.A. § 162(a) (West Supp. 1987)). Section 162(a) provides that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Id. Classification of an activity as a trade or business generates significant tax savings to an individual, as the expenses incurred in engaging in this activity may be fully deductible. See Freed, Factors that Will Establish that a Taxpayer's Activity Constitutes a Trade or Business, 31 Tax'n FOR Acct. 90, 90 (1983). Such a deduction is permitted even if the amount of the deduction exceeds the amount of gross income derived from the trade or business in a given tax year. See Treas. Reg. § 1.162-1(a) (as amended in 1975). However, trade or business expenses must be directly, not remotely related to the conduct of such an activity. See Treas. Reg. § 1.62-1(d) (as amended in 1983). If an activity is not considered a trade or business, the taxpayer's ability to deduct such expenses is lost or limited. See Freed, supra, at 90. Deductible trade or business expenses include management expenses, labor, supplies, insurance premiums, and advertising and selling expenses. See Treas. Reg. § 1.62-1(a) (as amended in 1975).


For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) Trade and business deductions.—The deductions allowed by this chapter . . . which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

Id. Expenses incurred while rendering services as an employee are not considered a trade or business deduction. See Treas. Reg. § 1.62-1(d) (as amended in 1983).

\(^3\) See 26 U.S.C.A. §§ 61(a)(2), 62(a)(1) & 162(a) (West Supp. 1987). A taxpayer's gross income includes any income or profit derived from his business activities. See id. § 61(a)(2). The term "income" comprises all "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). Adjusted gross income is an intermediate computation falling between gross income and taxable income, see 1987 U.S. Master Tax Guide (CCH) § 1004, which is computed by reducing an individual's gross income by the "above-the-line" deductions enumerated in section 61. See 2 J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 1.13[2] (1957). In contrast, "below-the-line" deductions, are subtracted from adjusted gross income to arrive at an individual's taxable income. See id. However, under the Tax Reform Act of 1986, certain "below-the-line" or itemized deductions have been accorded less favorable tax treatment; they are deductible only to the extent that the
“trade or business” as used in these sections of the Code has not been defined by Congress or the Internal Revenue Service (“IRS”). The scope of “trade or business” activities has been determined by an ad hoc examination of the facts of each case. 

aggregate of all the “below-the-line” deductions exceed two percent of the taxpayer’s adjusted gross income. See 26 U.S.C.A. § 67(a) (West Supp. 1987). Consequently, “above-the-line” deductions, which may be taken in full, are more valuable tax-wise than “below-the-line” deductions. See 2 J. Rabkin & M. Johnson, supra, § 1.13[2].

In order to effectuate Congress’ intent to tax all gains except those explicitly excluded from income, courts have liberally construed the meaning of income. See Glenshaw Glass Co., 348 U.S. at 430. In contrast, deductions are a matter of legislative grace and have been narrowly interpreted by the courts. See New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). Since their inception, federal income tax laws have allowed the deduction of expenses attributable to the pursuit of a trade or business. See Note, The Trade or Business Issue: Can A Gambling Loss Properly Be Considered A Business Loss?, 19 Suffolk U.L. Rev. 907, 907 n.1 (1985) [hereinafter Note, The Trade or Business Issue]. The congressional policy underlying this deduction is to ensure parity in the amount of tax paid by different categories of taxpayers. See S. Rep. No. 885, 78th Cong., 2d Sess. (1944), reprinted in 1944 C.B. 858, 877-78 (discussing predecessor section of § 162). By reducing an individual’s gross income by the amount of his trade or business expenses, his gross income becomes comparable for tax rate computations to that of an employee earning a salary. See id. at 878.

4 See Higgins v. Commissioner, 312 U.S. 212, 215 (1941). This term is mentioned in at least 492 subsections of the Code and in 664 Treasury Regulations. See Boyle, What Is A Trade or Business?, 39 Tax L. W. 737, 737 (1986). However, the term has different connotations and consequences depending on the particular Code section at issue. See id. at 764.

The development of the term “trade or business” can be traced back to 1861 and the enactment of the first federal income tax law, which levied a tax on “income . . . derived from any kind of property, or from any profession, trade, employment or vocation.” Bolling & Carper, The Evolving Definition of “Trade or Business”: Ditunno and Beyond, 63 Taxes 73, 74 (1985). Treasury Regulations promulgated to clarify the Income Tax Act of 1861 used the words “trade or business” in tandem. See Messamer, What Constitutes a Trade or Business Under Federal Income Tax Laws, 3 U. Kan. L. Rev. 99, 101 (1954). However, the words “trade or business” were not used together statutorily until the Revenue Act of 1916 in which section 5(a) authorized the deduction of trade or business expenses when computing net income. See Bolling & Carper, supra, at 75.

5 See Comment, Defining “Trade or Business” Under the Internal Revenue Code: A Survey of Relevant Cases, 11 Fla. Sr. U.L. Rev. 949, 976 (1984) [hereinafter Comment, Defining “Trade or Business”]. To determine whether an activity is a trade or business, the majority of jurisdictions employ the Higgins test, which examines the facts of a particular course of conduct to determine if the level of business-related activity undertaken by a taxpayer is sufficient to qualify as a trade or business. See Comment, Gajewski Gambles on Taxes in the Second Circuit, 51 Brooklyn L. Rev. 1135, 1143 (1985) [hereinafter Comment, Gajewski Gambles on Taxes]. A minority of courts advocate the use of an alternate test devised by Justice Frankfurter in his concurring opinion in Deputy v. du Pont, 308 U.S. 488 (1940), which requires that an individual hold himself out to others as offering or selling goods or services. See id. at 499 (Frankfurter, J., concurring). See also infra notes 40-41 and accompanying text.

By using the fact-intensive Higgins test, uncertainty has resulted as to what types of behavior are necessary or sufficient to confer trade or business status on an activity. See Comment, Defining “Trade or Business,” supra, at 976. Many activities a taxpayer may engage in are unequivocally a trade or business. See Boyle, supra note 4, at 750. However,
sequently, courts have reached inconsistent results in their tax treatment of individuals who gamble as the sole means of their livelihood. Several courts have denied trade or business status to a gambler because he did not hold himself out as offering goods or services to others. Recently, in Commissioner v. Groet-

the nature of some activities implicitly raises questions as to whether such activity is a trade or business as defined in the Code. See id. Generally, estates and trusts are not considered a trade or business. See, e.g., United States v. Pyne, 313 U.S. 127, 130 (1941) (expenses incurred administering estate are not deductible); City Bank Farmers Trust Co. v. Helvering, 313 U.S. 121, 126 (1941) (deduction of trustee fees as expense of trust disallowed). Courts differ as to whether services rendered by a taxpayer under an exclusive consulting agreement qualify as a trade or business. Compare Grosswald v. Schweiker, 653 F.2d 58, 58 (2d Cir. 1981) (services rendered by bank executive under exclusive consulting contract constitute trade or business) with Barrett v. Commissioner, 58 T.C. 284, 290 (1972) (corporate executive working under exclusive consulting contract with former employer not engaged in trade or business). Some courts refuse to premise qualification as a trade or business on an arbitrary distinction of whether an individual worked for one employer or more than one employer. See, e.g., Grosswald, 653 F.2d at 61 (“It makes little sense to distinguish between a person who ‘holds himself out’ to only one employer . . . and a person who ‘holds himself out’ to more than one employer.”).

Compare Wells v. Commissioner, 48 T.C.M. (CCH) 1200 (1984) (gambler is engaged in trade or business) and Ditunno v. Commissioner, 80 T.C. 362 (1983) (same) with Noto v. United States, 770 F.2d 1073 (3d Cir. 1985) (gambler is not engaged in trade or business) and Gajewski v. Commissioner, 723 F.2d 1062 (2d Cir. 1983) (same), cert. denied, 469 U.S. 818 (1984). Prior to the Ditunno decision in 1983, the Tax Court uniformly had held that an individual who gambled on a consistent and regular basis for his own account was not engaged in a trade or business. See, e.g., Gentile v. Commissioner, 65 T.C. 1 (1976). Adopting Justice Frankfurter’s goods or services test, the Tax Court consistently had concluded that placing wagers or laying down bets did not constitute an act of offering goods or services to others. See id. at 6. The court had analogized the gambling activities at issue in Gentile to cases involving the management and investment of one’s own financial resources, a passive activity which courts routinely held did not qualify as a trade or business. Id.

The Tax Court reversed its position in Ditunno, and held that a gambler need not offer goods and services to others to be within the definition of trade or business under section 62(a)(1). Ditunno, 80 T.C. at 371. In Ditunno, the taxpayer regularly gambled on horse racing six days a week throughout the year. Id. at 363-64. Although the taxpayer used his own money to gamble, the court found gambling distinguishable because the daily wagering, the studying of racing forms and the risk-taking inherent in betting constituted a greater degree of activity than the passive investment of one’s money. Id. at 371-72. Presently, the Seventh and Eleventh Circuits follow the Tax Court’s position. See Groetzinger v. Commissioner, 771 F.2d 269 (7th Cir. 1985), aff’d, 107 S. Ct. 980 (1987); Nipper v. Commissioner, 746 F.2d 813 (11th Cir. 1984).

See Note, The Business of Betting: Proposals for Reforming the Taxation of Business Gamblers, 38 Tax Law. 759, 761 (1986). The Second, Third, and Sixth Circuits require that an individual hold himself out as offering goods or services to others in order to qualify as a trade or business. See, e.g., Estate of Cull v. Commissioner, 746 F.2d 1148 (6th Cir. 1984) (full time gambler was not in trade or business as he did not offer services to others), cert. denied, 472 U.S. 1007 (1985); Gajewski v. Commissioner, 723 F.2d 1062 (2d Cir. 1983) (daily jai-alai betting not trade or business under du Pont test), cert. denied, 469 U.S. 1066 (1985); Noto v. United States, 598 F. Supp. 440 (D.N.J. 1984) (full-time horse racing gam-
the Supreme Court held that an individual who earns his living by gambling is engaged in a trade or business if he wagers with regularity, consistency and an intent to make a profit, thus refuting the contention that the offering of goods or services to others is necessary to qualify as a trade or business.  

In Groetzinger, the taxpayer devoted approximately 60 to 80 hours per week in 1978 to pari-mutuel wagering at greyhound racetracks and won $70,000 on bets of $72,032. However, Groetzinger reported only the $6,498 he received from nongambling sources as his gross income for the year, did not deduct his gambling losses, and calculated his tax liability accordingly.  

After an audit, the Commissioner determined that Groetzinger's gross income included his $70,000 in winnings and that his gambling losses, pursuant to section 165(d) of the Code, could be deducted as an itemized deduction to the extent of his winnings. The Commissioner further concluded that Groetzinger was subject to the alternative minimum tax provisions of section 56(a) of the Code and that portions of his gambling losses were thereby taxable as an item of tax preference. Consequently, Groetzinger was as-
sessed a total deficiency of $2,522, of which $2,142 was directly attributable to the taxpayer's gambling activities.\textsuperscript{16}

The United States Tax Court determined that Groetzinger's endeavors were a trade or business within the meaning of section 62(a)(1) as his activities were "sufficiently regular, frequent, active and substantial."\textsuperscript{16} The classification of Groetzinger's activities as a trade or business resulted in the removal of his gambling losses from the alternative minimum tax computation and a reversal of the IRS deficiency.\textsuperscript{17} On appeal, the Seventh Circuit of the United

\textsuperscript{16} Groetzinger, 107 S. Ct. at 982.

\textsuperscript{16} Groetzinger, 82 T.C. at 795, 803. Noting its inability to derive a precise test or definition for trade or business from existing case law, the court adhered to its prior position in Ditunno v. Commissioner, 80 T.C. 362 (1983), and reasoned that qualification as a trade or business inherently is a question of fact. Groetzinger, 82 T.C. at 803. In addition, the court declined to require that a taxpayer must offer goods or services to others in order to qualify as a trade or business. See id. at 803.

\textsuperscript{17} See id. at 795. Trade or business expenses were deductions in the computation of adjusted gross income; they were not considered an item of tax preference under the alter-
States Court of Appeals, unanimously affirmed the holding of the Tax Court.\textsuperscript{18} Noting a conflict among the circuits on this issue, the Supreme Court granted certiorari and thereafter affirmed the Seventh Circuit's decision.\textsuperscript{19}

Writing for the Court, Justice Blackmun stated that prior emphasis on the facts and circumstances test of \textit{Higgins v. Commissioner}\textsuperscript{20} provided no "readily helpful standard" to determine the existence of a trade or business under sections 62(a)(1) and 162(a) of the Code.\textsuperscript{21} Based on its interpretation of \textit{Higgins} and its progeny, the Court reaffirmed the validity of the facts and circumstances test and concluded that continuous and regular involvement by a taxpayer in an activity, coupled with an intent to make a profit from the pursuit of this endeavor, was sufficient to qualify an activity as a trade or business.\textsuperscript{22} Noting that some courts required that a taxpayer hold himself out as offering goods or services to others in order to confer trade or business status on his activities,\textsuperscript{23} the \textit{Groetzinger} Court declined to make this factor an absolute prerequisite to qualifying as a trade or business.\textsuperscript{24} Justice Blackmun concluded that Groetzinger's activities qualified as a

\textsuperscript{18} See \textit{Groetzinger v. Commissioner}, 771 F.2d 269 (1985), aff'd, 107 S. Ct. 980 (1987). Chief Judge Cummings argued that "the inquiry should concentrate on whether certain activities of a taxpayer can fairly be characterized as a livelihood, occupation or means of earning a living" and should examine the "continuity, repetition and extensiveness of activities and . . . the good faith intent of the taxpayer to make a profit or produce income." \textit{Id.} at 274. The court noted that trade or business activities are not limited to commercial and industrial activities, and include the arts, professions, athletics and the holding of public office. \textit{Id.} However, a personal activity, even if extensive or profitable, cannot be considered a trade or business. \textit{See id.}

\textsuperscript{19} \textit{Groetzinger}, 107 S. Ct. at 983, 988.

\textsuperscript{20} 312 U.S. 212, 217-18 (1941).

\textsuperscript{21} \textit{Groetzinger}, 107 S. Ct. at 986. The Court acknowledged that \textit{Higgins} and its progeny provided only holdings based on factual inquiries into the status of individual activities, not analysis or reasoning that might be followed by courts to determine whether a trade or business exists. \textit{Id.} at 984, 986.

\textsuperscript{22} \textit{Id.} at 986-87. Justice Blackmun declined to overrule or limit the Court's holding in \textit{Higgins}. \textit{See id.} at 988. The Court also noted that "[a] sporadic activity, a hobby or an amusement diversion" would not qualify under this standard. \textit{Id.} at 987.

\textsuperscript{23} \textit{Id.} at 987. The Second Circuit considers the holding out of one's self to society for the purpose of supplying goods or services for a fee to be a "universal characteristic of a businessman or trader in a free enterprise society." \textit{Gajewski v. Commissioner}, 723 F.2d 1062, 1066 (2d Cir. 1983), \textit{cert. denied}, 469 U.S. 1066 (1985). In examining cases adopting this test, the \textit{Groetzinger} Court concluded that these cases had created in gamblers a special class of taxpayers with special rules that had no basis in fact under the Code. \textit{See Groetzinger}, 107 S. Ct. at 987 n.14.

\textsuperscript{24} \textit{See id.} at 987.
trade or business under sections 162(a) and 62(a)(1) because he wagered in good faith on a regular and consistent basis with an intent to earn his livelihood by gambling.\textsuperscript{25}

In his dissent, Justice White argued that Congress' intent under section 162(a) was not to confer trade or business status on gamblers.\textsuperscript{26} While the dissent acknowledged the harsh effect of the alternative minimum tax in Groetzinger, it reasoned that the 1982 amendments to the alternative minimum tax provisions corrected this inequity by removing gambling losses from the alternative minimum tax base.\textsuperscript{27} Justice White further asserted that the Court's holding should be limited to cases arising under the provisions of the Code in effect in 1978.\textsuperscript{28}

The Supreme Court, through its holding in Groetzinger, has reasserted the validity of a fact intensive evaluation of the extent and nature of an individual's activities in determining the existence of a trade or business under section 162(a).\textsuperscript{29} While the Court reached an equitable result in holding that Groetzinger's gambling merited trade or business status, it is submitted that the Court's abbreviated analysis of the components of the Higgins test provides little guidance for lower courts when determining whether a disputed activity is a trade or business. This Comment will consider the factors relied upon by the Court in construing the applicability of the trade or business standard to questioned courses of conduct and will suggest that an examination of alternate provisions of the Code will clarify the facts and circumstances test of Higgins advocated by the Groetzinger Court.

**Evolution of the Meaning of Trade or Business**

The failure of Congress and the IRS to promulgate a working definition of trade or business\textsuperscript{30} historically has led to an ad hoc

\textsuperscript{25} See id. at 988.
\textsuperscript{26} See id. at 988 (White, J., dissenting).
\textsuperscript{27} See id. at 988 n.4 (White, J., dissenting). Justice White argued that Congress implicitly accepted the fact that gambling was not a trade or business when it amended the alternative minimum tax in 1982. See id. at 988-89 (White, J. dissenting). However, legislative history is silent as to Congress' rationale in excluding gambling losses from the alternative minimum tax. See S. REP. No. 494, 97th Cong., 2d Sess. 107-17, reprinted in 1982 U.S. CODE CONG. & ADMIN. NEWS 781, 875-884 (no mention of § 165(d) in discussion of changes in alternative minimum tax).
\textsuperscript{28} See Groetzinger, 107 S. Ct. at 989.
\textsuperscript{29} See id. at 988.
\textsuperscript{30} See Bolling & Carper, supra note 4, at 73. The failure of Congress and the Treasury
judicial determination of the tax status of an individual's activities. In *Flint v. Stone Tracy Co.*, the Supreme Court broadly construed "business" to encompass a wide spectrum of activities subject to a corporation tax under the Tariff Act of 1909. The Court held that any activity "which occupies the time, attention and labor of men for the purpose of a livelihood or profit" is a business. Subsequently, in *Higgins v. Commissioner*, the Court narrowed the scope of activities within the ambit of this statutory term when it considered the deductibility of trade or business expenses under the precursor of section 162(a). Although asserting that qualification as a trade or business requires "an examination of the facts in each case," the *Higgins* Court failed to provide any concrete standard by which its decision could be applied. As a result, courts have inconsistently applied the facts and circumstances test. In analyzing the components of this test, several jurisdictions had adopted the position advocated by Justice Frankfurter

Regulations to uniformly define trade or business in the Code can be attributed to the fact that this term is intended to have different meanings depending on the particular provision in which it is used. See id.

See, e.g., id. at 73 (meaning of term developed by courts on case by case basis); Boyle, supra note 4, at 738 (no definitive judicial definition has evolved); Note, *The Trade or Business Issue*, supra note 3, at 907-08 (judicial interpretation of term is less than definitive).

220 U.S. 107 (1911).

See id. at 171. In *Flint*, the Court concluded that holding and managing real estate was within the statutory meaning of "business" in the Corporate Tax Act. See id. *Flint*, which was decided two years before the sixteenth amendment provided authorization for a federal income tax, upheld the constitutionality of the Corporate Tax Act as an excise tax on corporations. See id.

Id. at 171 (citation omitted). The Court stated that "'[b]usiness' is a very comprehensive term and embraces everything about which a person can be employed." Id. (citation omitted).

312 U.S. 212 (1941).

See Bolling & Carper, supra note 4, at 75. In *Higgins*, the taxpayer deducted expenses incurred while managing and overseeing his extensive investments in real estate, bonds and stocks. See *Higgins*, 312 U.S. at 213. The taxpayer devoted a substantial amount of time to this activity and hired a staff to assist him. See id. The Court held that personal investment activity could not constitute a trade or business and disallowed the deduction. See id. at 218.

Id. at 217. In formulating this approach, the Court considered and rejected the *Flint* definition. See id.

See supra note 5.

See Deputy v. du Pont, 308 U.S. 488, 499 (1940) (Frankfurter, J., concurring). In *Deputy v. du Pont*, E.I. du Pont de Nemours & Company desired to sell a portion of its stock to its executives for business reasons, but legal problems prevented the company from selling the stock directly to its executives. See id. at 490. The taxpayer, as beneficial owner of sixteen percent of du Pont stock, undertook the sale of stock to the executives but did
and required that in order to be classified as a trade or business, an individual must hold himself out as providing goods or services to others.\textsuperscript{40}

Individuals who earn their livelihood through legalized gambling are not engaged in a trade or business under Justice Frankfurter's analysis because placing a wager for one's own account cannot be equated with the offering of goods or services to others.\textsuperscript{41}

\textsuperscript{40} See, e.g., Estate of Cull v. Commissioner, 746 F.2d 1148, 1152 (6th Cir. 1984) (gambler does not hold himself out as provider of goods or services), cert. denied, 472 U.S. 1007 (1985); Grosswald v. Schweiker, 653 F.2d 58, 61 (2d Cir. 1981) (retired employee acting as consultant for former employer meets goods or services test); McDowell v. Ribicoff, 292 F.2d 174, 178 (3d Cir.) (fiduciary is not in trade or business as he does not hold himself out as provider of services), cert. denied, 368 U.S. 919 (1961). See generally Note, The Business of Betting: Proposals for Removing the Taxation of Business Gamblers, 38 TAX LAW. 759, 764-69 (1985) (discussing judicial acceptance of Justice Frankfurter's test).

\textsuperscript{41} See supra note 6. See also Gajewski v. Commissioner, 723 F.2d 1062, 1067 (2d Cir. 1983) (at minimum, gambler must meet goods or services test), cert. denied, 469 U.S. 1066 (1985). Strict adherence to the goods or services test would require gamblers such as Groetzinger, who wagered solely for his own account, to establish bookmaking operations or solicit wagers from others so as to properly hold themselves out as offering goods or services. See Comment, Gajewski Gambles on Taxes, supra note 5, at 1160-61 n.150. Such promotion of arguably illegal gambling operations for tax-saving purposes contravenes the public policy underlying federal and state anti-gambling statutes, see id. at 1161, and may possibly expose an individual to criminal or civil liability or both. See, e.g., 18 U.S.C. § 1955 (1982); N.Y. PENAL LAW § 225 (McKinney 1985). Federal law provides that "[w]hoever conducts, finances, manages, supervises, directs, or owns all or part of an illegal gambling business shall be fined not more than $20,000 or imprisoned not more than five years, or both." 18 U.S.C. § 1955(a) (1982). In New York State, an individual who knowingly "engages in conduct which materially aids any form of gambling activity . . . includ[ing] but . . . not limited to . . . the solicitation or inducement of persons to participate therein," N.Y. PENAL LAW § 225.00(4) (McKinney 1985), is guilty of a Class E felony, see id. § 225.10, and may be subject to a prison sentence of not more than four years or a fine of $5,000, or both. See id.
In contrast, judicial and administrative precedent confers trade or business status on a "stock trader" who gambles in the stock market solely for personal benefit despite the fact that he does not hold himself out as offering goods or services to others. Using the factual analysis advocated in *Higgins*, courts have examined the nature and frequency of the taxpayer's trading activities in the stock market as well as his investment goals when considering whether an individual is a "stock trader." Refusing to differentiate between the tax treatment to be given "stock traders" and gamblers, the *Groetzinger* Court determined that satisfying Justice § 80.00 (McKinney 1987).

See, e.g., *Snyder v. Commissioner*, 295 U.S. 134, 139 (1935) (speculating on stock market may constitute trade or business). Courts, in considering the existence of a trade or business, distinguish between a stock trader and an individual who merely invests in the stock market. See, e.g., *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983) (mere investor not entitled to business deduction); *Purvis v. Commissioner*, 530 F.2d 1332, 1334 (9th Cir. 1976) (per curiam) (same). A "stock trader" has been characterized as an individual who "has bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis." *Chaing Hsiao Liang v. Commissioner*, 23 T.C. 1040, 1043 (1955). A stock investor is one who purchases and holds securities for an extended period of time to receive the benefit of capital appreciation of the stock and income from dividends and interest paid out on the stock. See *Moller*, 721 F.2d at 813.

Investment is considered a personal activity, not a trade or business, because all taxpayers in addition to their occupation or livelihood engage in investing in some form and to some degree. See *Groetzinger v. Commissioner*, 771 F.2d 269, 275 (7th Cir. 1985), aff'd, 107 S. Ct. 980 (1987). As Chief Judge Cummings noted in *Groetzinger*:

> [P]ersonal investment to preserve or protect the fruits of one's labor is not the investor's livelihood or occupation, but rather an activity dealing with the surplus wealth arising out of one's occupation. . . . The fact that one person has accumulated more wealth than another, by means of toil or simply good fortune . . . would not justify allowing the wealthier taxpayer the benefit of trade or business treatment of the larger-scale investment activity.

*Id.* See also *Higgins v. Commissioner*, 312 U.S. 212, 218 (1941) (extensive investment in real estate, stocks and bonds not a trade or business); *Moller*, 721 F.2d at 811 (management of own portfolio not trade or business).

See Weiss, *Tax Results of Investment Expenses Depend on Whether Taxpayer is a Trader or Investor*, 20 TAX'N FOR ACC'N. 42, 42, 44 (1978). The Supreme Court has acknowledged cases which hold that "a taxpayer who, for the purpose of making a livelihood, devotes a major portion of his time to speculating on the stock exchange may treat losses thus incurred as having been sustained in the course of a trade or business." *Snyder*, 295 U.S. at 139. Investment activities of a speculative nature which involve high volume trading and short term holding will satisfy the frequency and level of activity required of a stock trader. See Weiss, supra, at 42, 44. In *Levin v. United States*, a taxpayer devoted his entire business day to stock market activities, made investment decisions based on his personal investigations and derived the majority of his income from his trading activities. See *Levin v. United States*, 597 F.2d 760, 765 (Cl. Ct. 1979). The court found the taxpayer to be engaged in a trade or business based on the continuity of his investment activity, his direct management of his portfolio and the extensive quantity of his transactions. See *id.*
Frankfurter's goods or services test was not an absolute requirement for designation as a trade or business. It is submitted that by abrogating the goods or services test, the Groetzinger Court correctly eliminated an artificial distinction that had inequitably precluded an individual's chosen occupation from receiving the full tax benefits available under the Code.

**APPLICATION OF THE Higgins Test**

Analyzing the Higgins test, the Groetzinger Court delineated two requirements for imposing trade or business status under section 162(a): continuity and regularity of involvement in an activity and an intent to make a profit. It is submitted that simply by restating the components of the Higgins test without outlining the criterion to be used in this analysis, the Court created a standard that will be difficult to administer. Moreover, this refinement of the facts and circumstances test impacts on any endeavor seeking to qualify as a trade or business under section 162 and without clarification of the Groetzinger criterion, the scope of activities qualifying as a “trade or business” may be inadvertently enlarged.

**A. Profit Motive**

By stating that classification as a trade or business requires an intent to make a profit, the Groetzinger Court has imposed on lower courts a duty to examine the motivation of a taxpayer who pursues a particular occupation without defining the parameters of this inquiry. While profitability is a proper criterion of trade or

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44 Groetzinger, 107 S. Ct. at 987. Courts generally have not required a “stock trader” to hold himself out as offering goods and services. See, e.g., Levin, 597 F.2d at 765 (factual analysis used to determine individual was stock trader); Purvis, 530 F.2d at 1332 (factual analysis necessary to determine if trade or business). By using the facts and circumstances test of Higgins, courts have adhered to a definition of trade or business that emphasizes inquiry into the means by which an individual earns his livelihood. See Groetzinger, 771 F.2d at 275.

Commentators consistently have urged the demise of the goods or services test, and the uniform adoption of the facts and circumstances test. See, e.g., Boyle, supra note 4, at 763 (fairer result likely when “artificial” goods and services test is abandoned); Note, The Trade or Business Issue, supra note 3, at 924, 926 (facts and circumstances test is in accord with established tax principles); Comment, Gajewski Gambles on Taxes, supra note 5, at 1168 (facts and circumstances test superior to goods and services test).

46 Groetzinger, 107 S. Ct. at 987.

46 See id. Determining whether a course of conduct was undertaken with the requisite profit motive necessarily is a subjective inquiry into the intentions, motivation and good faith of a taxpayer. See Boyle, supra note 4, at 743. Courts have been vague in construing
business status, it is suggested that the use of section 183 of the Code to determine the intentions of a taxpayer would clarify this component of the Higgins test. Section 183 limits the deductibility of expenses incurred in an "activity not engaged in for profit."  

the nature of the "profit motive" needed to satisfy this requirement. See, e.g., Snyder v. United States, 674 F.2d 1359, 1363 (10th Cir. 1982) (good faith expectation of a profit required); Stanton v. Commissioner, 399 F.2d 326, 328 (5th Cir. 1968) (business must be carried out in good faith for purpose of making profit).

See Bolling & Carper, supra note 4, at 77. It is a well-settled principle that a taxpayer's business deductions will be disallowed if the circumstances indicate that the taxpayer lacked an intent to make a profit in his pursuit of this activity. See id. See also Stanton, 399 F.2d at 328-29 (taxpayer's attempts to invent storm-proof boat lacked "profit motive" and not trade or business); Besseney v. Commissioner, 379 F.2d 252, 257 (2d Cir.) (business expenses deduction denied because taxpayer's horse breeding activities lacked bona fide intent to make profit), cert. denied, 389 U.S. 931 (1967).

26 U.S.C.A. § 183 (West 1982). Section 183 reads in pertinent part:

(a) General rule.—In the case of an activity engaged in by an individual . . .

if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(b) Deductions allowable.—In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed—

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).


Section 183 limits or disallows deductions for any activity not denominated a trade or business under section 162 or an activity not engaged in for the production of income under section 212. See Freed, supra note 1, at 90. Under section 162, expenses incurred in carrying on a trade or business are fully deductible. 26 U.S.C. § 162 (1983). Similarly, expenses incurred in the production of income pursuant to section 212 are deductible but the Tax Reform Act of 1986 allows a deduction only to the extent that such expenses exceed two percent of a taxpayer's adjusted gross income. 26 U.S.C.A. § 212 (West Supp. 1987). To qualify for preferred tax treatment both section 162 and section 212 require an intent to make a profit. See Freed, supra note 1, at 92.

Under section 183(b)(1), a taxpayer's non-business related expenses such as interest, state and local taxes and capital losses are deductible to the extent allowed in the Code. See S. REP. No. 552, 91st Cong., 1st Sess. 1, reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS 2027, 2135 [hereinafter 1969 U.S. CODE CONG. & ADMIN. NEWS]. Section 183(b)(2) allows deductions for expenses that would qualify as deductible expenses under section 162 or section 212 only to the extent that these expenses do not exceed the gross income derived from the activity as reduced by the deductions allowed under section 183(b)(1). See id.

Section 183 is most often used to determine the deductibility of expenses incurred in an activity characterized as personal or recreational, or relating to a sport or hobby. See, e.g., Rexroad, 1985 T.C.M. (P-H) ¶ 85,189, at 85-801 (Apr. 17, 1985) (boat racing not engaged in for profit so deduction of expenses in excess of income denied); Golanty, 72 T.C. 411, 430, 432 (1979) (deduction of expenses in excess of income denied as taxpayer's horse breeding
Under this provision, an “objective standard” of profitability is used to determine the intent of an individual. A taxpayer is required only to have entered into or continued in an activity with an “objective” of making a profit.49 A reasonable expectation of making a profit is not required.50 In addition, a taxpayer who

49 See 1969 U.S. CODE CONG. & ADMIN. NEWS, supra note 48, at 2134. Legislative history indicates that Congress explicitly intended that an objective standard be used when determining the profit motive of a taxpayer. See id. The Treasury Regulations promulgated under section 183 reinforce the use of an objective standard:

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 is in the venture for profit even though the expectation of a profit might be considered unreasonable. Treas. Reg. § 1.183-2(a) (1972).

In determining whether a taxpayer has an objective intent to make a profit, all relevant facts and circumstances are to be taken into consideration. See id. The objective facts in any given situation are to be given greater weight in determining profitability than the taxpayer’s own statement of intent. See id. The Treasury Regulation provides a list of factors relevant in a section 183 analysis:

1. Manner in which the taxpayer carries on the activity;
2. The expertise of the taxpayer or his advisors;
3. The time and effort expended by the taxpayer in carrying on the activity;
4. Expectation that assets used in the activity may appreciate in value;
5. The success of the taxpayer in carrying on other similar or dissimilar activities;
6. The taxpayer’s history of income or losses with respect to the activity;
7. The amount of occasional profits, if any, which are earned;
8. The financial status of the taxpayer; [and]
9. Elements of personal pleasure or recreation [involved in the activity].

See id. For a detailed discussion of this Treasury Regulation, see Freed, supra note 1, at 93-94. While no one factor is dispositive, it is submitted that use of these guidelines will allow courts to make a determination of profitability that is grounded in a factual basis and unhindered by the problems encountered in gauging an individual’s subjective motivations.

50 See supra note 49. Because there is no requirement of a reasonable expectation of making a profit, determining a taxpayer’s intent does not center on the amount of profit earned. See Treas. Reg. § 1.183-2(a) (1972). Under the “objective” formulation of profit, any taxpayer engaged in a highly speculative activity (such as inventing or wildcat oil investing) which holds only a small chance of making a large profit could qualify, even though the expectation of making a profit may seem unreasonable. See 1969 U.S. CODE CONG. & ADMIN. NEWS, supra note 48, at 2134. Failure to derive any income from an endeavor has not precluded a finding that a taxpayer had an intent to make a profit. See, e.g., Yancy, 1984 T.C.M. (P-H) ¶ 84,431, at 84-1739 (Aug. 13, 1984) (deduction allowed under section 183 despite taxpayers “foolish” and “misguided” expectation of profit since such intent was “actual and honest”).

Decisions concerning section 183 deductions generally employ an examination of the
makes a profit, no matter how small, for three out of five years is presumed to have an objective of profitability.\(^1\) It is submitted that the guidelines offered by section 183 and the Treasury regulations promulgated in connection with this provision provide a functional analysis by which a court may determine the profit motive of a taxpayer. It is further suggested that use of this criterion will avoid examination of the subjective intent and motivation of an individual, a determination that is often difficult and burdensome.

**B. Continuity and Regularity of Activity**

Continuity and regularity in carrying on an activity has been properly identified by the *Groetzinger* Court as a requisite to qualification as a trade or business.\(^2\) While the extent of activity required under this component of the *Higgins* test was not elaborated by the *Groetzinger* Court, "extensive activity over a substantial period of time" has been utilized as the appropriate standard.\(^3\) Similarly, under section 183, analysis of the profit motive outlined in Treasury Regulation § 1.183-2(b) to determine the profit motivation of a taxpayer. See, e.g., Harrington, 1984 T.C.M. (P-H) § 84,428, 84-1724 to -1726 (Aug. 9, 1984) (intent to make profit found in business-like manner in which business was run); Plunkett, 1984 T.C.M. (P-H) § 84,170, at 84-606 to -607 (Apr. 3, 1984) (mud racing activities recreational and not entered into for profit, but truck-pulling activities were engaged in for profit as taxpayer devoted substantial time and effort to activity, activity had significant profit potential, and taxpayer had expertise in activity).

\(^1\) See 26 U.S.C.A. § 183 (West 1986). Prior to the Tax Reform Act of 1986, Congress utilized a less restrictive standard of profitability by generally requiring a showing of profit in only two out of the five years a taxpayer pursues an activity. See Freed, supra note 1, at 92. Under the 1986 Act, the presumption now requires such a finding in three out of five years. See 26 U.S.C.A. § 183(d) (West 1986). However, no inference may be drawn that an activity is not engaged in for profit solely by the taxpayer's failure to show a profit for three out of five years. See Treas. Reg. § 1.183-1(c)(11) (1972).

\(^2\) See Commissioner v. Groetzinger, 107 S. Ct. 980, 988 (1987); Bolling & Carper, supra note 4, at 75 (regular and active involvement is required); Boyle, supra note 4, at 759 (extensive activity necessary).

\(^3\) See, e.g., Stanton v. Commissioner, 399 F.2d 326, 329 (5th Cir. 1968) (investor's efforts lacked continuity and regularity characteristic of trade or business); Hochman v. Commissioner, 51 T.C.M. (CCH) 311, 313 (1986) (casual and sporadic gambler not engaged in a trade or business). This criterion is met if a taxpayer concretely shows that he devoted a "substantial portion of his time" to the conduct in question or was involved in "extensive or repeated activity." See Stanton, 399 F.2d at 329. Whether a particular court adheres to the facts and circumstances test of *Higgins* or the goods or services test of Justice Frankfurter, courts have uniformly required continuous, extensive and substantial activity on the part of the taxpayer for the endeavor to be designated a trade or business. Compare McDowell v. Ribicoff, 292 F.2d 174, 178 (3d Cir.) (extensive activity over substantial period of time during which taxpayer holds himself out as selling goods or services), cert. denied, 386 U.S. 919.
tive of a taxpayer includes an evaluation of the time and effort expended by the taxpayer engaging in such activity. While an objective examination of intent may result in a finding that a taxpayer had the necessary profit motive, it is asserted that failure to combine a profit motive with an extensive and substantial course of conduct analysis under section 183 will result in sporadic and isolated instances of activity being designated a trade or business.

CONCLUSION

The Supreme Court's decision in Groetzinger has extended the tax advantages afforded a trade or business to an unconventional activity—private gambling for one's personal benefit. A fact based inquiry of a taxpayer's course of conduct is an inherently superior means of determining trade or business status and allows courts equitably to base their decisions on an analysis of the circumstances of the case without the artificial constraints imposed by the goods or services test. However, by merely reaffirming the importance of the Higgins test, the Groetzinger decision does little to resolve the issue of how to define the term "trade or business" under section 162(a) of the Code. Since qualification of an individual's course of conduct as a trade or business is currently a factual question determined by courts on an ad hoc basis, use of a standardized analysis under section 183 would help prevent casual and sporadic instances of activity from being afforded the tax benefits of a trade or business designation.

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(1961) with Groetzinger v. Commissioner, 771 F.2d 269, 274 (7th Cir. 1985) (continuity, repetition and extensiveness of gambling activities evaluated under Higgins test), aff'd, 107 S. Ct. 980 (1987) and Purvis v. Commissioner, 530 F.2d 1332, 1334 (9th Cir. 1976) (factual analysis included examination of frequency, extent and regularity of taxpayer's securities transaction).

See Treas. Reg. § 1.183-2(b)(3) (1972). By devoting a significant amount of time and effort to carrying on an activity, a taxpayer indicates an intention to make a profit. See id. For a detailed discussion of section 183, see supra note 48.