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The Hobby Loss Assault on Distributors of Direct Sellers—Hardly Justified and Particularly Unwarranted

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second balcony, each could still see the wondrous jewelry the speaker wore. "Welcome everyone to what promises to be an exciting two day journey through the challenges and riches of building your own business through direct selling. For the next two days we will show you tips to building your business through selling to and recruiting others," proclaimed the speaker.

John and Mary sat attentively through nearly 16 hours of meetings covering everything from building personal confidence to making sales to others to thoroughly learning about the products they sold and would sell in the near future. Heading home, they felt that the $500 they spent on travel, lodging, meals, and other expenses were well worth it.

Such a seminar is just one small part of operating a distributorship for a direct seller. John and Mary work, collectively, almost 20 hours each week trying to build their distributorship. They meet with potential customers while traveling away from home. Occasionally, personal and professional acquaintances come to their home where John and Mary discuss the exciting opportunities available by entering the business.

As a direct seller, commonly referred to as a distributor, John and Mary have a unique opportunity to own and operate a business. Direct selling provides them with flexibility to work as many hours each week on the business while not interfering with their current job. Distributors operating such a business must recognize that income received from their distributorship is taxable income. However, distributors are able to deduct ordinary and necessary business expenses associated with the distributorship operations and, if expenses exceed income, the resulting net loss reduces other income such as wages from the distributor's current job.

The Internal Revenue Code (the "Code") and Treasury Regulations provide an assortment of pitfalls and challenges to distributors seeking to deduct losses from their business against other income. A distributor who meets these challenges must still satisfy one last obstacle. The distributor must operate the business with the intent to make a profit. An intent to make a profit, as will be explained in greater detail in this article, is not a simple concept and the distributor must be aware of it.

Congress, concerned that taxpayers were deducting net losses from businesses that were not run with a profit motive, enacted legislation to require a profit motive before allowing a business loss deduction against other income (e.g. wages). This legislation, commonly referred to as the "hobby-loss rules," is the inspiration for this article.

The hobby-loss rules are the IRS' trump card used against taxpayers who have otherwise satisfied the requirements to deduct business expenses. Distributors, such as John and Mary, may be surprised to hear an IRS auditor assert during audit that their 16 hours of meetings and 20 hours per week working on the distributorship operations were *for nothing more than a hobby*. As an unfitting punishment for the freedom they have to build their distributorship, John and Mary may easily find themselves entangled in the nebulous world of proving they have a profit motive. Although any small business owner may find himself/herself under the profit motive microscope, distributors and their business operations may be misunderstood and unfairly treated.

It is the position of the author that the IRS and the courts have misapplied the intent of the hobby-loss rules to distributors. A short description is first provided of the direct selling industry. This article then explores the history of the hobby-loss rules to help explain why they have become such a powerful and misused weapon in the IRS' hands. Next, historical perspective is given to hobby-loss legislation pertaining not only to distributors, but other businesses. An in-depth analysis is made of how the Treasury Regulations and court cases under the hobby-loss rules result in unfair treatment for distributors. Finally, suggestions are made regarding legislative relief for distributors in the form of changing the law to make the hobby-loss rules inapplicable to direct sellers or extending the statutory presumption period for profit motive.

II. NATURE OF THE DIRECT SELLING BUSINESS

Direct selling companies (hereinafter Direct Sellers) typically do not sell their products through retail outlets. Instead, they depend upon the efforts of distributors (such as John and Mary) to bring their product to the public through personal, sometimes one-to-one, sales. These distributors thus operate their own business selling the Direct Seller's products to customers. The distributor usually earns income in two ways. First, retail sales are

lected breeding was influenced by a thought of winning stakes and purses. The taxpayers were wealthy enough to afford the occupation despite large losses. Thus, the court concluded that "if they were utterly indifferent to whether there was loss or gain or if it were shown that the stables were an incident to the social or domestic aspects of their daily lives, the result might be against them." [10] Instead, the taxpayers devoted themselves to promoting the stables and winning a single race could convert steady losses into a net profit.

2. 1943 Congressional Action. In 1943, Congress recognized that wealthy individuals were not being taxed on all of their income because of deductions taken for "business" losses. Congress sought to limit deductible "business" losses which it considered created by activities which were more like hobbies. Congress quickly realized that it would be difficult, if not impossible, to specifically determine whether or not a particular line of business was operated as a hobby. Legislative debate over the new law most decidedly pointed to its application to wealthy individuals and legislative debate underscored the concern Congress had regarding the unrestricted deductibility of business expenses against ordinary income. [11]

In addition to focusing upon the applicability of the legislation to wealthy individuals, concern was raised regarding the provision's application to various types of businesses and some senators voiced their concern as to the provision's broad applicability. [12] Eventually, the Senate debate turned to the effectiveness of the new provision. The fairness of the provision to taxpayers in general was also questioned. [13]

Section 130 [14] effectively pulled the tax benefit carpet out from under taxpayers who deducted large losses against other income for "business" related activities. Thus, after 1943, if the taxpayer incurred losses greater than $50,000 in any business endeavor for five consecutive years, his/her income tax would be recomputed as if losses above $50,000 had not occurred. The provision clearly was intended to apply to the wealthiest of individuals who deducted losses incurred from their hobby-business against ordinary income. Over the next 25 years, however, Congress understandably found this new Code provision to be of limited usefulness.

B. 1969 Act—Section 183 is Born

Congress realized that Section 270 (renumbered from Section 130) did not prevent the deductibility of large losses taxpayers were taking against other income. Section 270 also did not prevent taxpayers from carefully operating a "business" so that income and/or expenses were incurred in such a way as to avoid a $50,000 net loss in any year. For example, a taxpayer could deduct over $50,000 for four consecutive years and in the fifth, incur only enough expenses so that the taxpayer would only lose $45,000. In such a case, Section 270 would not apply.

Section 270 was repealed and replaced with a hobby-loss rule which prevented a taxpayer from deducting losses incurred in activities conducted without a profit motive. The new hobby loss provisions were a part of legislation limiting losses incurred by farmers. Congress was concerned with the deductions taken by part-time farmers for losses incurred in farming operations. Tables used in support for passage of legislation curtailing the losses deductible in farming operations and the

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[10] Id., at 658.
[11] 90 Cong. Rec. 224-25 (1944).
[12] Id., at 225-27.
[13] Id., at 227-28.
[14] Sec. 130 LIMITATION ON DEDUCTIONS ALLOWABLE TO INDIVIDUALS IN CERTAIN CASES.

(a) Recomputation on Net Income.—If the deductions (other than taxes and interest) allowable to an individual (except for the provisions of this section) and attributable to a trade or business carried on by him for five consecutive taxable years have, in each of such years, exceeded by more than $50,000 the gross income derived from such trade or business, the net income of such individual for each of such years shall be recomputed. For the purpose of such recomputation in the case of any such taxable year, such deductions shall be allowed only to the extent of $50,000 plus the gross income attributable to such trade or business, except that the net operating loss deduction, to the extent attributable to such trade or business, shall not be allowed.

Redetermination of Tax.—Upon the basis of the net income computed under the provisions of subsection (a), for each of the five consecutive taxable years specified in such subsection, the tax imposed by this chapter shall be redetermined for each such taxable year. If for any such taxable year assessment of a deficiency is prevented (except for the provisions of sections 3801 and 3807) by the operation of any law or rule of law (other than section 3761, relating to compromises) any increase in the tax previously determined for such taxable year shall be considered a deficiency for the purposes of this section. For the purposes of this section the term 'tax previously determined' shall have the meaning assigned to such term by section 3801(d).

Extension of Statute of Limitations.—Notwithstanding any law or rule of law (other than section 3761, relating to compromises), any amount determined as a deficiency under subsection (b), or which would be so determined if assessment were prevented in the manner described in subsection (b), with respect to any taxable year may be assessed as if on the date of the expiration of the time prescribed by law for the assessment of a deficiency for the fifth taxable year of the five consecutive taxable years specified in subsection (a), one year remained before the expiration of the period of limitation upon assessment for any such taxable year.

ness operations. The term "activity not engaged in for profit" is inherently subjective in nature, requiring a judgment call as to the deductibility of losses in essentially every case. Naturally, such judgment calls would lead to constant litigation.

IV. BACKGROUND AND FRAMEWORK OF SECTION 183

A. Importance of Business Activity

Congress enacted Section 183 to, in part, prevent taxpayers from requiring the public to finance activities which were operated like a hobby. [21] Section 183(a) provides that no deduction, except as provided in Section 183, is available to an individual or S corporation for activities "not engaged in for profit." [22] Thus, anyone who operates a "business" without a profit motive is subject to the deduction limitations of Section 183.

Section 183(c) provides that 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 Sections 162 or 212. The purpose of Section 183 is to require that an individual be carrying on a trade or business or an activity conducted for the production or collection of income or the management, conservation, or maintenance of property held for the production on income. [23] Section 183 will thus limit the deductibility of losses if the activity is not engaged in for profit.

B. Deduction Limitation

Section 183 does not completely deny a deduction for expenses incurred in activities which are not operated with a profit objective. Deductions are allowed for expenses:

(1) which would otherwise be allowable (interest and taxes) without regard to profit objective; and

(2) other business expenses (if engaged in for profit) to the extent that gross income exceeds the deductions allowed in (1) above. [24]

Those expenses which will not result in the adjustment of the basis of business property are taken first. [25]

If the expenses above do not exceed gross income, then expenses which would adjust the basis of property (depreciation expense) may be taken up to the amount of gross income left after the deductions stated above are taken. [26] Thus, the order and amount of deductions allowed under Section 183(b) for activities engaged in without a profit objective may be summarized as followed:

Gross Income		$ 1,000
Deductions allowed whether or not engaged in for profit:		
State Gasoline Tax	$ 300	
Casualty Loss	$ 400	
Deductions allowed		$ (700)
Maximum deduction under Section 183(b)(2)		$ 300
Other business expenses	$(1,200)	
Maximum business expense deduction		$ (300)[27]
Nondeductible business expense under Section 183		$ 900

C. Presumption of Profit

Section 183(d) provides a presumption to taxpayers that their activities are engaged in for profit if certain conditions are met. *Activities which satisfy the "presumption" requirements of Section 183(d) are thus engaged in for profit unless the IRS proves to the contrary.* The taxpayer must show a profit (gross income from the activity exceeds de-

[21] See text, supra, at notes 15-20.

[22] Section 183 is not applicable to C corporations.

[23] Section 183(c) specifically identifies an activity *not* engaged in for profit as *other* than one whose expenses are deductible under Sections 162 and 212(1) or (2). Section 162 refers to the deductibility of certain expenses for those carrying on a trade or business. Section 212 refers to the deductibility of expenses associated with the collection of income or management of property held for the production of income.

[24] IRC Sec. 183(b).

[25] Reg. § § 1.183-1(b)(1)(i) and (ii).

[26] Reg. § 1.183-1(b)(1)(iii).

[27] Reg. § 1.183-1(b)(3), Ex. (1).

advice has been sought but not followed, a lack of intent to make a profit is shown. [36]

Where a distributor seeks the advice of his/her sponsor or others to succeed in the business, the distributor should document well the advice, any results, follow-ups, and benefits. [37] In the direct selling industry, seeking out the expertise of advisors may involve more than speaking to the individual's sponsor. The distributor's sponsor is an important source of very useful information. In addition, a distributor is likely to receive and/or purchase books, tapes, or other business materials which will aid in the building of the individual's distributorship. John and Mary spent $500 to hear from experts in the business when they attended the seminar. John and Mary's attendance at the seminar certainly indicates a profit motive.

Regulations also indicate that where a taxpayer obtains advice but does not carry on the business accordingly, a lack of profit motive may be apparent unless it is shown that the taxpayer is trying to develop new techniques that may result in profitability. [38] John and Mary, after coming home from the seminar, will apply what they learned in operating their distributorship and experiment with the selling techniques they learned to determine which ones are most successful and disregarding the others. This experimentation process does not mean that John and Mary are ignoring the advice of those who advise them. Instead, they are showing a profit motive by applying the advice which best meets their needs. Thus, the existence of the family of individuals in a particular line of sponsorship in and of itself provides participants in the direct selling industry with more than adequate compliance with this portion of the regulations.

3. The time and effort the taxpayer expends carrying on the activity. A taxpayer who devotes a substantial amount of personal time to a business that provides limited personal pleasure should be able to show a profit objective for the activity. [39] A distributor should document the number of hours spent in the active conduct of the distributorship. It may be helpful to categorize the time spent on the different activities. [40]

By far, the most important determinative factor of profit motive for a distributor should be the amount of time and effort the distributor spends on his/her distributorship. For individuals whose distributorship is his/her only source of income and full time profession, this factor is easily satisfied. For those individuals whose distributorship is a part time activity because of employment elsewhere, time spent on the distributorship must be examined more closely. Distributors with a profit objective spend many frustrating hours trying to sell product or sponsor others into the business. These distributors will often spend many hours of what would otherwise have been free time with their family in order to build their business and ultimately become profitable.

In the process of attempting to build their business, these active distributors may incur substantial expenses in the initial years of operation. Many of the activities take the form of meeting with others who may be customers or who may be interested in joining the business or purchasing products. Naturally, a new distributor would seek out customers from those he/she knows best—family and friends. Accordingly, the IRS and courts may incorrectly interpret these activities as merely an extension of the distributor's social life.

There may be isolated examples of distributorships that do nothing more than purchase products for personal use but conduct very little outside activity to build the business. These distributors may incur substantial expenses beyond their business income by attending seminars or meeting others with only a "half-hearted" attempt to build the business and, therefore, to make a profit. It should come as no surprise that the Tax Court takes a dim view of the profit objective of such distributors who devote little time to the business operations. [41] Conversely, distributors who use substantial amounts of their free time to meet business prospects easily establish a profit motive.

4. Expectation that assets used in the activity may appreciate in value. An unprofitable business operation may nevertheless be run with a profit objective where the assets used in the business may increase in value. [42]

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[36] Reg. § 1.183-2(b)(2).

[37] See *Leonard*, supra, note 32—the taxpayer sought advice from experts; *Doyle v. Com.*, CCH Dec. 39,535(M), 45 TCM 231 (1982)—taxpayer had no prior experience in the business but relied upon advice from experts.

[38] Reg. § 1.183-2(b)(2).

[39] Reg. § 1.183-2(b)(3).

[40] See *Ellis v. Com.*, CCH Dec. 40,970(M), 47 TCM 991 (1984)—profit motive established where taxpayers established that they spent several hours each day on the business; *Faulconer*, supra, note 32—the taxpayer spent almost all of his time on the farming operations.

[41] See, e.g., *Dinsmore v. Com.*, CCH Dec. 49,752(M), 67 TCM 2537 (1994), aff'd on this issue 96-1 USTC ¶ 50,177 (CA-6).

[42] Reg. § 1.183-2(b)(4). The taxpayer showed a profit objective in *Jasienski v. Com.*, CCH Dec. 48,652(M), 64 TCM 1369 (1992) for business cars that were

some would argue that to allow a distributor time to build the business invites abuse from distributors to incur and deduct unnecessary expenses. Such an argument would be specious. The IRS and courts would deny a deduction for an expense which was not ordinary and necessary under Section 162. There are therefore adequate protections available to the IRS and courts to allow reasonable losses during the start-up phase of a distributorship.

7. The amount of occasional profits. The amount of profits in relation to losses incurred, investment made, and the value of the assets used may be useful in determining profit motive. [49] A taxpayer may be able to show a profit motive if he/she abandons an activity that has produced losses over a period of time. [50]

Once again, the "amount of occasional profits" referred to in Reg. § 1.183-2(b)(7) is not necessarily applicable to distributors. It is clear from Reg. § 1.183-2(b)(7) that speculative ventures, where the potential for large profits exists, were contemplated.

A distributorship is typically not entered into for speculative purposes. Thus, a large gain in one particular year is unlikely. A distributor is more likely to slowly increase income while gaining control of expenses. Courts should carefully examine the reasonability of expenses in relation to income received. Distributors who are actively engaged in building the business are likely to incur substantial expenditures related to automobile and seminar expenses to sell products, develop customers, learn about new products, and sponsor other distributors in the initial years. Once a line of sponsorship grows, income increases while the proportionate amount of expenses decreases.

8. The taxpayer's financial status. It may be difficult for a taxpayer to show a profit objective if he/she has income from other sources, losses from the activity create a tax benefit, and there is personal pleasure involved in the activity. [51] Conversely, where a taxpayer does not have substantial income from outside sources, a profit motive may be apparent. [52] The court in *Ranciato v. Commissioner* [53] concluded that the taxpayer's status as a middle income taxpayer should have been taken into account by the Tax Court in deciding whether the taxpayer's pet store was run with a profit motive. The Second Circuit in *Ranciato* recognized that the legislative history of Section 183 indicated that the lack of profit objective determination should have been made taking into consideration the taxpayer's financial status. The Second Circuit concluded that Ranciato was not the type of taxpayer about whom Congress was concerned when determining the profit motive requirement. Ranciato was a middle class wage earner for whom, according to the court, an unprofitable outside activity would not shelter much other income.

The Tax Court's conclusion that Ranciato, a middle income taxpayer, did not operate his pet store with a profit motive illustrates a significant challenge to distributors with losses in consecutive years of operation. Such distributors will likely find no support from the Tax Court no matter what their financial status is despite the legislative history of Section 183. On remand from the Second Circuit, the Tax Court [54] seemingly disregarded the Second Circuit's focus on the legislative history of Section 183 as it pertained to middle income taxpayers. The Tax Court found that Ranciato lacked a profit motive and concluded that "regardless of his income level, we doubt that he would willingly engage year after year in this unprofitable activity unless he had a motive other than profit. We infer that he kept the store open because he and his mother received benefits for operating it independent of its ability to earn a profit." [55]

In light of the legislative history of Section 183, the Tax Court's position in *Ranciato* is wholly unwarranted. The economic status of a distributor, for example, should be given great weight in determining if a profit motive exists. Distributors who have little to gain by losing money in a distributorship (i.e., middle income taxpayers in the 15 or 28 percent tax bracket) should be accorded great deference in determining profit objective. The ease of entry into and out of the direct selling industry affords distributors the opportunity to explore the business opportunity to determine if it will ulti-

[49] Reg. § 1.183-2(b)(7).

[50] See *Snyder v. Com.*, CCH Dec. 44,290(M), 54 TCM 953 (1987) and *Harrison v. Com.*, 72 TCM 1258 (1996).

[51] Reg. § 1.183-2(b)(8).

[52] In *Phillips*, supra, note 32, the taxpayers argued that the large amount of their income and all of their inheritance spent on the horse breeding operation indicated that they had a profit motive. In *Daugherty*, supra, note 32, the taxpayer's outside income allowed him to incur losses in his farming operation. However, the taxpayer could not afford to continue the losses without expecting profit in the future.

[53] *Ranciato v. Com.*, 95-1 USTC ¶ 50,194, 52 F3d 23 (CA-2).

[54] *Ranciato v. Com.*, CCH Dec. 51,170(M), 71 TCM 2116 (1996).

[55] Id. at 2119.

tion of Section 183. For example, taxpayers providing personal services in the vocation of artist, [62] writer, [63] drag racing, [64] real estate broker, [65] attorney, [66] photography, [67] and treasure hunting [68] have been subjected to Section 183. In farming and related activities, taxpayers conducting a cattle ranch and farming, [69] dog breeding, [70] and horse breeding [71] activities have had their losses scrutinized. Even taxpayers with businesses that would typically be considered retail have encountered challenges under Section 183. For example, taxpayers with a nursery, [72] crafts, [73] boat chartering, [74] and pet store [75] business have been attacked under Section 183. Finally, taxpayers conducting direct sales activities have also been successfully attacked by the IRS under Section 183. [76]

D. Application of Section 183 to Distributors

The way a distributor conducts his/her business will have a significant impact upon whether Section 183 will be applicable. Accordingly, an analysis of court cases involving distributors is required to determine the characteristics the court finds indicative of a distributorship operated with or without a profit motive. These cases are instructive to distributors and emphasize the need to operate the distributorship with a profit motive.

These cases also demonstrate a troubling analytical aspect for distributors undergoing such an examination. Where courts do examine distributorships using the nine factors in the regulations, little care or understanding is given to the unique aspect of the direct selling business.

In *Dinsmore v. Commissioner*, [77] the taxpayer sought to deduct a substantial loss incurred in a Select Care distributorship dealing with dog grooming products. The taxpayer purchased the Select Care distributorship for his son to operate. The taxpayer provided funds for the operation and kept a separate bank account. However, the son operated the business and the taxpayer had no authority to sign checks. Gross receipts from the business were $5,662 with deductions of $36,394.

The Tax Court found that the taxpayer's activities were not engaged in for profit. The court cited the list of nine factors in the regulations but did not review each. The court simply found that the taxpayer did not carry on the activity in a businesslike manner. The factors that tended to show that there was a lack of profit motive included a lack of bookkeeping records, bank statements, canceled checks, records of credit card transactions and distributorship agreement.

The court also indicated that the taxpayer should have investigated the profitability of the business and that he had no training or experience and relied upon the advice of his attorney and his former wife. Another factor showing that the taxpayer had no profit motive was that he spent very little time in carrying on the activity and there were not any assets which would appreciate in value.

In *Herrick v. Commissioner*, [78] the taxpayer entered into a distributorship agreement to distribute a tire pressure monitoring system and radar detection device. The distributorship agreement included a substantial distributor use fee and recourse and nonrecourse promissory notes. The taxpayer never received any marketable or functional product and deducted expenses associated with the distributorship. The court concluded that the taxpayer conducted the distributorship primarily to secure certain tax advantages identified in the distributorship prospectus. The court determined that the taxpayer had no experience dealing with the automotive parts and did not properly evaluate the business opportunity.

The court concluded that "failure to make such elementary inquiries and to obtain expert advice in the transaction of the magnitude of this one is not consistent with the ordinary sound busi-

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[62] *Stasewich v. Com.*, CCH Dec. 51,429(M), 72 TCM 1 (1996).

[63] *Dreicer v. Com.*, CCH Dec. 38,948, 78 TC 642 (1982).

[64] *Casida v. Com.*, CCH Dec. 36,179(M), 38 TCM 1054 (1979).

[65] *Bradbury v. Com.*, CCH Dec. 51,293(M), 71 TCM 2775 (1996).

[66] *Beard v. Com.*, CCH Dec. 50,447(M), 69 TCM 1768 (1995). But see *Westphal v. Com.*, CCH Dec. 50,204(M), 68 TCM 1038 (1994).

[67] *Windisch v. Com.*, CCH Dec. 51,498(M), 72 TCM 361 (1996).

[68] *Hezel v. Com.*, CCH Dec. 41,811(M), 49 TCM 458 (1985). But see *Harrison v. Com.*, supra, note 50.

[69] *Hrdlicka v. Com.*, CCH Dec. 42,289(M), 50 TCM 675 (1985). But see *Roberts v. Com.*, CCH Dec. 43,827(M), 53 TCM 517 (1987).

[70] *Glenn v. Com.*, CCH Dec. 50,844(M), 70 TCM 453 (1995), aff'd, unpub. op. 97-1 USTC ¶ 50,101 (CA-6 1996). But see *Larson v. Com.*, CCH Dec. 47212(M), 61 TCM 2085 (1991).

[71] *Yates v. Com.*, 72 TCM 1193 (1996). But see *Dawson v. Com.*, CCH Dec. 51,552(M), 72 TCM 624 (1996).

[72] *Gagnon v. Com.*, CCH Dec. 51,566(M), 72 TCM 701 (1996).

[73] *Paxton v. Com.*, CCH Dec. 47,348(M), 61 TCM 2630 (1991).

[74] *Lewis v. Com.*, CCH Dec. 48,373(M), 64 TCM 269 (1992).

[75] *Ranciato v. Com.*, supra, note 54.

[76] See text, infra, at notes 77-83.

[77] *Dinsmore v. Com.*, CCH Dec. 49,752(M), 67 TCM 2537 (1994), aff'd on this issue 96-1 USTC ¶ 50,177 (CA-6).

[78] *Herrick v. Com.*, CCH Dec. 42,272, 85 TC 237 (1985).

to sell their company's products more effectively and become profitable. In addition, John and Mary will most likely spend hundreds, if not thousands, of dollars in automobile expenses trying to build a customer base and/or recruit others into the business. During this process, they will have spent hundreds of hours away from their home in the pursuit of future profits. Unfortunately, the first few years of operations may produce little income. Is their distributorship a hobby? Would it make any difference if they kept immaculate records? Is it credible to believe that they would spend, for example, $9,000 of their life savings in order to achieve a $1,350 tax savings (15 percent tax bracket)?

In 1969, Congress recognized that cattle and horse raising activities needed special attention because of the nature of the business. No such special treatment has been afforded to the direct selling industry. The direct selling industry has grown to such an extent that Congress should carefully consider the particular nature of distributors and their activities. Congress recognized that direct sellers should be treated in a specific manner, as independent contractors, in enacting Section 3508.

The time has arrived to acknowledge that direct selling provides a unique business opportunity to individuals and that a law written nearly 30 years ago to limit the deductibility of losses of wealthy individuals for "businesses" not run for profit did not adequately anticipate such an entrepreneurial endeavor. Accordingly, Congress should exempt direct sellers to whom Section 3508 applies from the application of the hobby loss rules. Thus, properly substantiated expenses would be disallowed only under Sections 162 and 262. Direct sellers to whom Section 3508 applies would then be given a fair opportunity to develop their business without interference from the government.

Should Congress be unwilling to adopt such legislation, the Section 183(d) rebuttable presumption should be extended for distributors. Distributors should be given a reasonable start-up phase, for example five to seven years, to cultivate their customers and sponsored distributors. The rebuttable presumption, in light of this start-up phase, might be extended to two out of eight years. The start-up phase, standing alone, would also support the profit motive of a distributor with several consecutive years of losses in the beginning of the distributorship.

Moreover, IRS pronouncements should acknowledge that the nine factors in the Treasury Regulations do not necessarily apply to distributors in the direct selling industry in the same way they do to, for example, farmers or painters. Finally, Treasury could accomplish the same by modifying the nine factors to take into account the nature of the direct selling industry as indicated above.

These suggested modifications are not designed to give distributors freedom to conduct their business in a haphazard and unbusinesslike manner. Distributors will not be able to mix personal and business expenses. In essence, legislative changes or otherwise should be marked to achieve a specific goal for distributors while retaining the integrity of Section 183. That specific goal is to not treat as a hobby the business of the distributor who is actively trying to build that business. Such activity may evidence itself in the form of additional expenses in the first few years of operations while the distributorship "family" and customer base grows. Good faith unsuccessful attempts to recruit others into the business and develop customers (together with the accompanying expenses) should be given just as much weight in determining profit motive as the size of the distributorship group. Such changes or considerations would give distributors a fair opportunity to establish a profit motive if challenged.

VIII. CONCLUSION

Section 183 and its underlying regulations are not well designed for distributors in the direct selling industry. Court cases involving distributors underscore the difficulties facing distributors if the IRS challenges whether losses from their distributorship are deductible under the hobby loss rules. These cases have not identified, specified, or analyzed the unique nature of the direct selling industry. Direct selling is growing in popularity as a business form and it is time for Congress to recognize such and protect distributors.