

FROM THE GARAGE TO THE INFORMATION SUPERHIGHWAY: TAX CONSEQUENCES FOR INDIVIDUAL EBAY USERS AND IRS POLICY TOWARD THE ONLINE MARKETPLACE

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I. THE TAX GAP: DEFICIENCIES IN IRS POLICY

Presently, the “tax gap”—the difference between the amount of federal income tax due and the amount American taxpayers actually pay—has, by government estimates, surpassed \$345 billion and shows no signs of slowing.¹ One potential contributor to the tax gap is underreported income from Internet trading or transactions (a.k.a. “e-commerce”) facilitated by providers such as Internet super-giant eBay Inc. The site’s creator, Pierre Omidyar, saw little progress in the first year of online trading, but in 2005 eBay reported more than 181 million registered users.² In fact, in that same year, eBay’s website grossed approximately \$44.3 billion.³

Auctions have ancient roots in early civilization and have gained extraordinary popularity in the online world in recent years. In the recent past, the creation of the modern Internet has become intertwined with this traditional trading platform. Many sole proprietors have found using Internet auction sites so advantageous and cost-effective that they have closed their physical storefronts and reopened their businesses in the virtual world.⁴ As a

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1. *GAO Says Reducing Tax Gap Requires Increased Scrutiny of Sole Proprietors*, Daily Tax Rep. (BNA) No. 156, at G-6 (Aug. 14, 2007) [hereinafter *Reducing Tax Gap*]; see Barney Tumeay, *Small Business/Self-Employed Division Plans More Audits to Reduce Tax Gap*, Daily Tax Rep. (BNA) No. 182, at G-8 (Sept. 20, 2006). The IRS calculates the tax gap based on estimates derived from random audit samples, then subtracts late payments and collections to make the determination. *Id.* Essentially, the tax gap is caused by of three major types of violation: non-filing, underreporting, and underpaying. *Id.*

2. eBay Inc., Annual Report (Form 10-k), at 2 (Feb. 23, 2006), available at <http://files.shareholder.com/downloads/eBay/176662371x0x43771/6D8B8042-3A58-4050-BF9F-52D1F5BE5F06/AnnualReport2005.pdf>. The author has chosen to discuss eBay as an example of the plethora of auction-style websites available to the average Internet user, and any change in IRS tax policy or reporting laws should apply to all online auction sites. Furthermore, eBay was chosen for its preminent status in the field of web-based auctions, and the public’s overall familiarity with this company.

3. Letter from Pierre Omidyar, Founder and Chairman, eBay Inc., and Meg Whitman, President and CEO, eBay Inc., to eBay Stockholders (Feb. 23, 2006) (available as attachment to eBay Inc., Annual Report, *supra* note 2) [hereinafter Letter from Pierre Omidyar].

4. See Tom Sowa, *Local eBay Sellers Grint It Out in Hopes of Finding Web Wealth*, THE SPOKESMAN REV., Aug. 1, 2004, available at <http://www.spokesmanreview.com/business/story.asp?ID=18415>.

group, sole proprietors are responsible for “[n]early 20 percent of the roughly \$345 billion in unpaid taxes owed to the federal government.”⁵

The term e-commerce refers to the use of electronic media to purchase goods or services through an “online” interface.⁶ Online platforms may take the form of Internet websites, intranets, or any form of electronic data sharing between two separate, remote locations.⁷ The key to understanding the problems e-commerce poses to tax compliance is knowing how such transactions occur. The basic structure of e-commerce provides consumers from any location with the ability to purchase any tangible good or service without interaction with a physical storefront. This anonymity and remote interaction enables both consumers and vendors to transact outside the scope of physical realms, where typical commercial activities take place. The lack of a physical location leads to serious legal issues⁸ and potentially inhibits the Internal Revenue Service (“IRS”) from tracking this section of the business world. Tax avoidance harms all of society, as it is the remainder of taxpaying citizens who must shoulder the increased burden from these illegal activities.

The first section of this article seeks to explore the history of two seemingly independent features of human interaction: the Internet and auctions. Next, the current tax dilemma created by their combined use will be compared to another seemingly unique aspect of our culture—horse breeding. The IRS has previously dealt with tax avoidance by tailoring laws to curb the problem, while also benefiting favored activities such as horse breeding and other profit seeking ventures.⁹ In response to the present situation, this article advocates that the Internal Revenue Code (“Code”)¹⁰ should be analyzed again, with the goal of creating revisions for the taxation of online auction income analogous to those which solved the horse-breeding tax dilemma. In addition to updating the Code’s application, this article proposes simple changes in the regulation and understanding of e-commerce to reverse the current trend of tax avoidance. Although the law traditionally lags behind technological developments in society, the explosion of e-commerce in the last decade should compel Congress and the Treasury Department to make significant improvements before this explosion deteriorates traditional tax concepts, leaving a meaningless shell of irrelevant concepts unsuited to regulating the virtual world.

5. *Reducing Tax Gap*, *supra* note 1, at G-6.

6. Internal Revenue Serv., Electronic Business, <http://www.irs.gov/businesses/small/article/0,,id=108188,00.html>.

7. *Id.*

8. *See, e.g.*, Richard A. White, *Overcoming Regulatory Barriers to Successful eCommerce*, in *E-COMMERCE : STRATEGIES FOR SUCCESS IN THE DIGITAL ECONOMY* 705, 707-08 (Craig W. Harding & Christine A. Varney eds., 1999).

9. *See infra* Part II.C.

10. I.R.C. §§ 1-1000 (2000).

A. Net Neutrality and E-Commerce Tax Avoidance

The IRS has sought to combat the tax gap by increasing funding for individual taxpayer audits, as well as increasing the number of auditors who work for the IRS.¹¹ A majority of the problem lies with self-employed individual filers who fail to report, or under-report, significant taxable income.¹² The next question becomes: how does eBay usage potentially contribute to the tax gap?

The modern Internet granted the general public access to the “information superhighway,” effectively creating a new marketplace for business. E-commerce¹³ allows the American consumer to sell or shop for merchandise without leaving home. During the Internet’s infancy, Congress resigned itself to taking a hands-off approach towards regulating or taxing this new marketplace.¹⁴ This line of thinking apparently still persists on Capitol Hill today, and eBay users are left with little assistance in deciding how to address the tax consequences of their website transactions. As a result, significant taxable income is being produced by eBay and its progeny. Many users are intentionally failing to comply with IRS reporting requirements, and the present regulations may not control usage or force individual taxpayer compliance.¹⁵ There is a lack of factual statistics¹⁶ quantifying how much eBay

11. Tumey, *supra* note 1, at G-8. During the Southern Federal Tax Institute’s forty-first annual meeting in September 2006, IRS Small Business/Self-Employed Division Commissioner Kevin Brown explained that increased audits would go a long way to curb the under-reporting of taxable income by self-employed individuals and small business owners. *Id.*

12. *Reducing Tax Gap*, *supra* note 1, at G-6. Currently, IRS estimates suggest that approximately 75% of the current gap has resulted from self-employed individuals who have avoided full compliance with current tax law. Tumey, *supra* note 1, at G-8.

13. The U.S. Census Bureau defines e-commerce as “[a]ny transaction completed over a computer-mediated network that transfers ownership of, or rights to use, goods or services.” Internal Revenue Serv., *Electronic Business*, *supra* note 6.

14. As of this article’s publication date, a moratorium exists on any sales tax or statutory regulation of Internet use. The Internet Tax Freedom Act (ITFA) barred any tax on Internet service providers or accompanying infrastructure. The act was slated to last for three years after its inception in 1998, but has been renewed on multiple occasions, and is currently extended to 2014. As recently as March of 2006, the moratorium was made permanent for some types of taxes applicable to e-commerce activities. *See* Internet Tax Freedom Act, Pub. L. No. 105-277, sec. 1101, 112 Stat. 2681-719 (1998); Internet Tax Nondiscrimination Act, Pub. L. No. 108-435, sec. 2-6A, 118 Stat. 2615-18 (2004); Internet Tax Freedom Act Amendments Act of 2007, Pub. L. No. 110-108, 121 Stat. 1024.

15. The IRS notes that compliance is the highest in situations where third-party reporting is required, as exemplified by required employer withholding of income and payroll tax from an employee’s paycheck. Internal Revenue Serv., *Understanding the Tax Gap* (Mar. 2005), <http://www.irs.gov/newsroom/article/0,,id=137246,00.html>; *see also* I.R.C. §§ 3102, 3402 (2000) (provisions regarding income and FICA tax).

16. “The IRS has not said how large the ‘tax gap’ might be from people who sell on eBay but don’t declare their earnings as income. Generally, the IRS is concerned with high-volume eBay sellers and not those individuals selling online as a hobby.” Sowa, *supra* note 4.

users actually contribute to the problem, and neither the IRS nor Congress has made any significant progress in addressing it.

B. The Cold War's Virtual Love-Child: The History of the Modern Internet in the Information Age

The Internet that exists today began under the guise of the acronym ARPANET.¹⁷ During its meager beginning, it became a research project of a specialized government agency, the Advanced Research Projects Agency (ARPA), which almost ceased to exist before ARPANET came into existence.¹⁸ The former military ballistic missile research agency was forced to justify its existence after the creation of NASA, and one of its new goals was to solve the difficult and mundane process of computer interfacing and transferring information across wide expanses and between varying programs.¹⁹ The solution was a network of computers with the revolutionary ability to allow multiple users to interact and compute complicated information at the same time.²⁰

ARPANET proved extremely successful, and before long similar “host” sites began cropping up at universities along the west coast of the United States.²¹ Unfortunately, the four initial sites did not draw the attention that a national system would have created.²² In 1973, the concept of “e-mail” was

17. KATIE HAFNER & MATTHEW LYON, *WHERE WIZARDS STAY UP LATE: THE ORIGINS OF THE INTERNET* 9-10 (1996). Despite the accolades paid to Mr. Gore, much credit can be given to President Dwight Eisenhower for the eventual creation of the Internet, as he initiated the Advanced Research Projects Agency (ARPA), the research group that eventually created ARPANET. *Id.* at 13-14. ARPA was created in the wake of the Sputnik launches during the early stages of the Cold War in an effort to produce a think-tank of the nation's scientific elite. *Id.* at 14-16.

18. *Id.* at 22. Hafner and Lyon's account of ARPANET's origins highlights the dire situation in which ARPA found itself after the establishment of NASA:

[B]y the late summer of 1958 the National Aeronautics and Space Administration had been enacted into law. Almost overnight, while [ARPA director] Johnson drummed for a military presence in space, the space projects and missile programs were stripped away from ARPA and transferred over to NASA or back to the [military] services, leaving ARPA's budget whittled to a measly \$150 million. ARPA's portfolio was gutted, its staff left practically without any role. *Aviation Weekly* called the young agency “a dead cat hanging in the fruit closet.”

Id.

19. *See generally id.* at 23-26.

20. *Id.* at 25-26. Previously, calculating machines, which spanned the length and width of entire rooms, were only able to perform one task at a time and could only be used by a single operator. *Id.* at 26.

21. *Id.* at 143-46.

22. *Id.* at 160 (“The network was real, but with only four nodes clustered on the West Coast, its topology was simple, the experiment small. East Coast computing powerhouses like MIT and Lincoln Laboratory, where so much was happening, weren't connected.”).

invented and became an integral part of this interconnected system of computer servers.²³ Various other forms of network joined ARPANET, and its popularity began to grow throughout the collegiate research community.²⁴ Eventually, what began as a justification for a small, under-funded agency expanded to mammoth proportions with unlimited potential. After decades of refinement and perfection, ARPANET fell to the wayside, and NSFNET became the most popular interconnected web system by the late 1980s.²⁵ By 1994, NSFNET and several other server sites provided the backbone of the World Wide Web, and word of the fast, efficient, and easy to use system they created spread like wildfire. The general public began embracing the modern Internet, and major businesses began to focus on developing a consumer market in the forum that traditionally had been confined to business-to-business transactions.²⁶

C. Traditional Auctions: A Business Solution with Unlimited Potential

Auctions typically involve an auctioneer presenting an item to a large group of bidders. The seller of the item often predetermines a minimum acceptable price for sale, and once that minimum is reached, the auctioneer will grant the highest bidder the opportunity to close the sale and obtain ownership of the item.²⁷ Rules dictating the manner in which the auction is held and the application of sales or use taxes often vary by state.²⁸

Traditional notions of auction-style sales began forming as early as 500 B.C.E., during the reign of the Greek Empire.²⁹ Auctions served primarily to quicken the pace at which the sale of war spoils and brides for wealthy, single men occurred.³⁰ However, even in early times, the potentially limitless uses for auctions were recognized.³¹

23. HAFNER & LYON, *supra* note 17, at 187-89.

24. *See id.* at 167-68.

25. *Id.* at 254.

26. *Id.* at 257.

27. *See generally* RALPH CASSADY, JR., AUCTIONS AND AUCTIONEERING (1967).

28. *See* Kelly L. Frey, Sr. et al., *eBay, eCommerce, eLaws*, TENN. BAR. J., Aug. 2006, at 27, available at http://www.tba.org/Journal_TBArchives/200608/TBJ-200608-ebay.html.

29. One famous passage from the Old Testament would suggest auctions were commonplace several centuries earlier, as when Joseph was auctioned off into slavery by his envious brothers. *Genesis* 37:28.

30. Marcus Aurelius, Roman Emperor, employed auctions to sell off personal property from his family's estate to settle debts. Nat'l Auctioneers Ass'n, *History of Auctions*, http://www.auctioneers.org/web/2007/06/history_of_auctions.aspx.

31. For example, in 193 B.C.E., the Praetorian Guard assassinated the emperor of Rome and sold the entire empire to the highest bidder. *See* CASSADY, *supra* note 27, at 29. Obviously this transaction was illusory, but Didius Julianus, the "highest bidder," obtained control over the empire by paying each guard the sum of 6,250 *drachmas*. *Id.*

Auctions arrived in America along with early settlers, as animal pelts, goods, and slaves were traded in open-air markets to the highest bidder.³² During the Civil War, Northern soldiers sold captured properties and goods in much the same manner as Greek and Roman armies had centuries earlier—via auctions.³³

During the 1950s, auctions diversified, covering an ever-expanding realm of business transactions, including real estate sales, stock, and many other items not traditionally sold at auctions.³⁴ The dawn of the Internet age provided an even greater array of commerce ripe for auction. With the creation of websites like eBay and Yahoo, bidders were now able to purchase items from all over the world without leaving their home. Along with other forms of e-commerce, Internet auction sites quickly gained popularity. Instead of gathering at weekend yard sales, garage sales, or regulated auctions, the public was able to find all of these items at one place. Unfortunately, the revolutionary creation of the Internet left Congress and the IRS unable to effectively predict and plan exactly how to address the federal income tax consequences of e-commerce, including online auctions.

D. Replacing the Gavel with Megabytes: eBay's Historic Rise to Online Dominance

The eBay Corporation opened its virtual bidding floor in 1995.³⁵ In a little more than a decade, this meager web page expanded to become one of the Internet's biggest success stories, with users spanning the globe and an incalculable number of products flowing from user to user through the site.³⁶ eBay officials assert that the company is not responsible for how the millions of sellers report income derived from auctions on their federal income tax returns.³⁷

32. See Nat'l Auctioneers Ass'n, *supra* note 30.

33. Auctioneers became popularly known as "colonels" because most of these auctions were actually supervised and run only by officers of that rank. *Id.*

34. "Auctioneers were now businessmen who dressed in suits and ties. They began to nurture the business and raise the reputation of auctioneers. Besides the public, auctioneers began to have links to banks, attorneys, accountants, the court system and government agencies." Nat'l Auctioneers Ass'n, *supra* note 30.

35. eBay Inc., Annual Report, *supra* note 2, at 1. Ironically, the site's original name was "Auction Web," though the word "auction" has been effectively deleted from the company's literature, except in South Korea where it is still used to describe the site. Frey et al., *supra* note 28, at 27, 31 n.3.

36. eBay reports that as of year-end 2005, there were approximately 1.9 billion products listed. eBay Inc., Annual Report, *supra* note 2, at 53. These listed products produced over \$44.3 billion in merchandise volume. Letter from Pierre Omidyar, *supra* note 3.

37. According to one report:

Hani Druzy, an eBay spokesperson, confirmed that eBay does not keep track of transactions on a running basis. . . . eBay doesn't store more than 30 to 90 days worth of data in your "My eBay" account. . . . Druzy says that

One of the most troubling aspects of eBay is how to define the self-proclaimed “Internet marketplace.”³⁸ Many have classified eBay as an Internet auction site; its home state of Tennessee, however, has enacted specific legislation that exempts the corporation from existing auction law.³⁹

eBay describes its user experience:

as online commerce platforms that enable a global community of buyers and sellers to interact and trade with one another. [eBay’s] role is to create, maintain, and expand the functionality, safety, ease-of-use, and reliability of [its] commerce platforms while, at the same time, supporting the growth and success of [its] community of users.⁴⁰

Although the website does not include the classic features of an auction such as a banging gavel, quick-talking auctioneers, or looming crowds of interested on-lookers, the transactions are nonetheless the same—and like any auction house, eBay takes a percentage of the sale price.

The virtual world has enabled the convergence of many types of business transactions that previously stood independently of each other. Accordingly, those who derive significant income from eBay transactions are required by law to report such income on their tax return.⁴¹ Consequently, taxpayers are faced with the decision of how to report their Internet-based income. The range of potential income-generating situations is broad: former bargain shoppers at weekend flea market sales may find a niche market for their collectibles; a struggling store owner may find a larger consumer base and lower costs by maintaining a business online; or a casual user may sell one or

eBay does not give tax advice and, when asked, will encourage members to consult their own tax professionals.

Eva Rosenberg, *Tax Consequences of Selling on eBay*, CBSMARKETWATCH.COM, Apr. 17, 2004, <http://www.marketwatch.com> (choose “Search” from Tools and Research menu; search “Tax Consequences of eBay”; select hyperlink to Rosenberg article).

38. In eBay’s annual report, the term “marketplace” is used throughout to describe the nature of the website, while use of the term “auction” is carefully avoided. *See* eBay Inc., Annual Report, *supra* note 2.

39. Frey et al., *supra* note 28, at 27. Tennessee is not the only state to enact such legislation.

In 2005, Maine passed a bill to exempt Internet services from auctioneer licensing. Similarly, Ohio passed a bill that amended the statute that regulates auctioneers. . . . [T]he attorney general of California indicated that eBay was not within the licensure provisions The attorney general of North Dakota has issued a similar opinion with respect to licensing eBay under auction statutes

Id. (footnote omitted).

40. eBay Inc., Annual Report, *supra* note 2, at 2.

41. The Code’s definition of “gross income” encompasses accessions to wealth from any source. *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955); *see also* I.R.C. § 61 (2000).

two items for more than they were originally purchased. Current law does not reflect the difference between the virtual business world and physical reality. Present tax law must be updated to curb contributions to the tax gap from e-commerce transactions that are not being closely monitored by the IRS, yet lawmakers should be careful not to impede the fluidity of the Internet that users currently enjoy.

II. THE 1986 TAX CODE APPLIED TO THE TWENTY-FIRST CENTURY E-COMMERCE

No short answer exists to explain how the IRS will view an individual's eBay-related activities.⁴² Consequently, even the most honest taxpayer may inadvertently fail to comply with the current federal income tax law.⁴³ The rise of e-commerce and Internet super-giants like eBay and Yahoo has created both an opportunity and an obstacle to deflating the tax gap.⁴⁴ Historically, garage sales and swap meets involved sales between individuals of personal property for little profit, and most often for less than the item was originally purchased.⁴⁵ Although eBay has cultivated this weekend hobby into a profitable business venture for many, the IRS has apparently failed to recognize its true tax potential.⁴⁶ Auction sites such as eBay make it possible for thousands of transactions which might otherwise occur in isolated front

42. The concept of a world wide web connecting billions of buyers and sellers, all with different intentions towards using the interface, was surely not contemplated during the development of the 1986 Code. Therefore, a substantial gray area exists between eBay users who fall under the section 162 trade or business category and those within the section 183 hobby losses category. See I.R.C. §§ 162, 183 (2000).

43. See eBay Inc., Annual Report, *supra* note 2, at 19-20 (compliance with tax authority requests for information).

44. eBay and its competitors have the technology to track user sales, but unfortunately records are disposed of because the IRS has not required these Internet-based companies to monitor third-party transactions for tax purposes. See *id.* In addition, these sites centralize transactions carried out by various vendors who may previously have owned and operated physical locales not so easily monitored by the IRS.

45. Under the current Code, if items of personal property were held solely for personal use and then sold on eBay for less than they were originally purchased, then there are no tax consequences that would require the seller to report the sale as income on his or her federal income tax return. See I.R.C. § 1001(a) (2000).

46. The IRS annually publishes a list of the top twelve most problematic tax avoidance schemes currently hindering the tax collection system. The 2006 list does not mention under-reporting of income derived from online selling, which seems troublesome when considering the \$34 billion in sales a year that flow through eBay alone. See Internal Revenue Serv., *IRS Announces "Dirty Dozen" Tax Scams for 2006* (Feb. 7, 2006), <http://www.irs.gov/newsroom/article/0,,id=154293,00.html>. The agency listed such scams as Internet "phishing" (identity theft) and defrauding charitable organizations, yet failed to mention that many eBay users are unaware of the tax consequences when using eBay, or believe the IRS is powerless to enforce tax provisions against eBay users who fail to comply with the Code. *Id.*; see also James Edward Maule, *The First Ten Tax Urban Legends*, post to MAULEDAGAIN.COM, http://mauledagain.blogspot.com/2005_03_01_mauledagain_archive.html (Mar. 29, 2005).

yards, parking lots, and town squares—or which might never have taken place at all, if not for the convenience of the online marketplace—to flow through just a few websites, and the IRS does not have the resources to monitor all of those activities.⁴⁷

A. Decoding the Code: The Section 162/183 Dichotomy and Its Relation to eBay Usage

The Code defines income expansively, and courts typically adopt a broad approach to the concept. Taxpayers can succeed on the merits where they are able to adequately demonstrate a profit motive,⁴⁸ although the IRS does not always acquiesce to a court's analysis. Under section 162, the Code outlines what constitutes a trade or business expense, while section 183 defines restrictions on hobby losses.⁴⁹ Section 212 applies to expenses incurred for the production of income.⁵⁰ Unfortunately, these three competing sections leave an expansive gray area as to taxpayers' e-commerce and similar activities that may or may not yield a profit.⁵¹

Business expenses are allowable deductions from gross income if they are incurred through carrying on a trade or business.⁵² Specifically, such expenses

47. See generally Maura Keller, *Going Once, Going Twice: Online Auctions Mean Big Business for Some*, Aug. 12, 2002, <http://hffo.cuna.org/14953/article/291/html> (last visited Sept. 4, 2007).

48. Still, the presumption is against the taxpayer, unless section 183 applies and shifts the presumption to favor the taxpayer. I.R.C. § 183(d) (2000). Furthermore, courts have been reluctant to state precisely what facts would prevent the IRS from overcoming section 183's presumption. See, e.g., *Nissley v. Comm'r*, 79 T.C.M. (CCH) 2105, 2109 (2000) (no one factor or majority of factors definitively upholds the profit motive presumption).

49. See generally I.R.C. §§ 162, 183 (2000).

50. See I.R.C. § 212 (2000).

51. Note that section 212 has filled some of the gap by allowing deductions for ordinary and necessary expenses incurred from property held for the production of income. *Id.* The Tax Court has supported the IRS's assertion that section 212 applies in situations where a taxpayer has incurred significant expenses to produce income, but fails to meet section 162's trade or business requirements. *Woodward v. Comm'r*, 397 U.S. 572, 574 (1970) (affirming Tax Court's finding that expenses paid for assessment of stock value was capital expenditure and not deductible as expenses for production of income under section 212).

52. In a savings and loans case, the Supreme Court provided five factors for expenses to qualify under 162(a) business expense deductions. The expense must:

- (1) be "paid or incurred during the taxable year,"
- (2) be for "carrying on any trade or business,"
- (3) be an "expense,"
- (4) be a "necessary" expense, and
- (5) be an "ordinary" expense. .

Comm'r v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 352 (1971) (citations omitted).
The Court continued:

In *Welch* Mr. Justice Cardozo emphasized the difference between the "ordinary" and the "necessary" and the need for satisfying both in order to

must be the ordinary⁵³ and necessary⁵⁴ costs of maintaining a trade or business to qualify as a business deduction.⁵⁵ If a taxpayer lacks the requisite intent or profit motive,⁵⁶ then section 183 may be applied to the activity. However, under section 183, deductions are only allowed up to the amount of profit for that year.⁵⁷ Finally, if taxpayer activities evidence legitimate profit motive,⁵⁸ but do not rise to the level of a trade or business, expenses may still be deducted under the ordinary and necessary standard of section 212.⁵⁹

The standard for deductions under section 212 is the same as the section 162 standard applied to a trade or business.⁶⁰ In addition, determining whether a taxpayer's activities reach the level of "ordinary and necessary" is a

achieve the deduction. It is in that case where his well-known, but elusive, suggestion for the answer appears:

"The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle."

Id. at 353 (quoting *Welch v. Helvering*, 290 U.S. 111, 115 (1933)).

53. The Court has defined "ordinary" costs as expenses that are common to a trade or business, and that are currently deductible, as opposed to capitalized investments that must be devalued over time if they are deductible at all. *See, e.g., Comm'r v. Tellier*, 383 U.S. 687, 689-90 (1966); *A. Giurlani & Bro. v. Comm'r*, 119 F.2d 852, 856 (9th Cir. 1941); *Southland Royalty Co. v. United States*, 582 F.2d 604, 606 (Ct. Cl. 1978).

54. *Welch*, 290 U.S. at 113 (defining necessary as "appropriate and helpful" to taxpayer's business).

55. I.R.C. § 162(a) (2000).

56. Section 183(d) of the Code provides taxpayers with a presumption of profit motive, but the IRS has been able to overcome this presumption regularly, even in horse breeding cases. *Montagne v. Comm'r*, 88 T.C.M. (CCH) 417, 419 (2004) (finding circumstances clearly showed that activities were engaged in for personal interest in horse breeding, despite claims from taxpayer that horse breeding venture was engaged in for profit). *See also* Treas. Reg. § 1.183-2 (1986). For a list of factors considered in making a profit motive determination, see Treas. Reg. § 1.183-2(b) (e.g., manner in which activity is conducted, relevant expertise of taxpayer, time and effort spent, expectations, success, elements of personal enjoyment, financial status, etc.).

57. I.R.C. § 183(b) (2000).

58. There is a presumption against the taxpayer where section 183 does not apply. For example, in *Hayden v. Commissioner*, the Sixth Circuit held that profit is determined by all relevant circumstances "independent of tax savings" and that there is a presumption in favor of the IRS's initial determination. 889 F.2d 1548, 1552 (6th Cir. 1989).

59. *See* *Woodward v. Comm'r*, 397 U.S. 572, 575 n.3 (1970).

60. Section 212 of the code provides:

In the case of an individual, there shall be allowed as a deduction all the *ordinary and necessary* expenses paid or incurred during the taxable year—

- (1) for the production or collection of income;
- (2) for the management, conservation, or maintenance of property held for the production of income; or
- (3) in connection with the determination, collection, or refund of any tax.

I.R.C. § 212 (2000) (emphasis added); *see also* *Trust of Bingham v. Comm'r*, 325 U.S. 365, 368 (1945) (discussing standard under predecessor provision to section 212).

question of fact for the trial court to decide.⁶¹ However, the two rules differ in that section 212 provides taxpayers deductions where activities are engaged in for profit but do not rise to the level of a trade or business.⁶² Still, a taxpayer must show “profit motive” for the expenses to be deductible under section 212, which is another factual determination for courts to decide.⁶³ If the activities do not meet the profit motive standard, then taxpayers still have the option to deduct expenses to the extent a profit is realized under section 183.⁶⁴

B. Hobby Loss or Business Deduction: A Presumption to Assist Taxpayers

The significance in distinguishing whether an activity is categorized as a trade or business, a for-profit activity, or a hobby is manifested most when losses are incurred. Activities labeled as hobbies, or ones lacking elements of a trade or business, that produce financial losses are only deductible up to the amount of profit derived from that activity.⁶⁵ In 1969, Congress recognized an inadequacy in tax treatment of profitable activities that do not prove successful for a number of years versus situations where taxpayers were using poor investment opportunities to offset gains from other ventures.⁶⁶ The 1954 Code’s section 270 proved ill-equipped to deal with taxpayers who spread losses over several years and used section 270 as a tax shelter to offset profits with hobby losses.⁶⁷ The Code was amended in 1969 to establish specific guidelines to curb this practice, but special measures were also incorporated to alleviate the pressures on some favorable activities, specifically horse breeding.⁶⁸ Section 183 of the Code replaced the repealed section 270,

61. *See, e.g.*, *Gorod v. Comm’r*, 42 T.C.M. (CCH) 1569, 1571-72 (1981).

62. I.R.C. §§ 162, 212; James Edward Maule, *Trade or Business Expenses and For-Profit Activity Deductions*, Tax Mgmt Portfolio (BNA), No. 505-2d, at A-21 (2005) (“If, in fact, a trade or business is being carried on, the determination of whether any deduction is allowable is made under [section] 162.”).

63. *See, e.g.*, *Nelson v. Comm’r*, 37 T.C.M. (CCH) 1204, 1205 (1978).

64. I.R.C. § 183(b) (2000).

65. *Id.*

66. Tax Reform Act of 1969, Pub. L. No. 91-172, sec. 213, 83 Stat. 571 (1969). The hobby loss provisions “were enacted to curtail or severely limit the practice of offsetting losses incurred in hobby-like activities against income from the taxpayer[’s] principal business or the source of his livelihood. . . . [T]he Congress and Treasury apparently consider it particularly applicable to gentleman farming.” Thomas A. Condon, Comment, *Section 183: Work Horse or Hobby Loss*, 20 CATH. U. L. REV. 716, 717 (1971) (citing *Hearings on H.R. 13270 Before the S. Comm. on Finance*, 91st Cong. 34-36 (1969)).

67. Allan J. Samansky, *Hobby Loss or Deductible Loss: An Intractable Problem*, 34 U. FLA. L. REV. 46, 47 n.6 (1981). “The impetus for enacting [section] 183 was a concern that taxpayers were often deducting hobby losses, particularly hobby losses incurred in farming.” *Id.* (citations omitted); *see also* Adam D. Chinn, Note, *Attacking Tax Shelters: Section 183 Leaves the Farm and Goes to the Movies*, 61 N.Y.U. L. REV. 89, 95-96 (1986).

68. *See* I.R.C. § 183(d). Many of the court cases explicating section 183 are directed towards farming and horse breeding activities, yet the rule applies equally to any type of “hobby” as defined under the statute. Condon, *supra* note 66, at 717.

eliminating the opportunity for taxpayers to hide large gains in activities purposely maintained at a loss.⁶⁹ Section 183(d) similarly permits a deduction for any activity that incurs losses in several preceding years but has proven profitable in three out of the last five taxable years.⁷⁰ In addition, under section 183(d), the statutory burden favors treating the taxpayer's activities as "for profit," unlike in typical tax controversies, in which the presumption is against the taxpayer.⁷¹

C. The Statutory History of the Horse Breeding Presumption and Its Modern Application

Essentially, the 1969 amendment to the Code sought to curb the inappropriate use of hobby losses as a tax shelter for otherwise taxable income from other sources while providing a more lenient standard where profitable activities required several years to fully develop.⁷² The special seven-year review period enacted for horse breeding activities was specifically proposed and included as an additional amendment on the Senate floor during the 1969 amendment debates.⁷³

Section 183 was passed primarily to benefit multiple facets of the farming and ranching industries. However, while horse breeding clearly mirrors typical cattle and other farming operations in many respects, horse breeding's potential as a source of income differs dramatically.⁷⁴ The costs associated with horse breeding often vary from those associated with other agricultural endeavors.⁷⁵ Except for the length of time it takes to prove profitable, horse

69. See generally Condon, *supra* note 66, at 717-18.

70. I.R.C. § 183(d). The hobby presumption is met when an activity proves to be profitable for three out of the previous five years. For the particular context of horse breeding activities, the second sentence of section 183(d) provides that "[i]n the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting '2' for '3' and '7' for '5.'" *Id.*

71. I.R.C. § 183(d).

72. See Chinn, *supra* note 67, at 91-93. Case law articulates the "real test" as "whether the operation was carried on as a business for gain or whether it was carried on for recreation or pleasure." *George v. Comm'r*, 22 B.T.A. 189, 195 (1931); *De Grazia v. Comm'r*, 21 T.C.M. (CCH) 1572, 1576 (1962).

73. See 115 CONG. REC. 28, 38295-97 (1969).

74. Successful horse breeding may lead to income derived from purse winnings, stud fees, and future winners bred from a single horse, whereas income derived from typical farming and cattle activities is based upon mass production over a large area, subject to the mercy of fluctuating market prices and acreage restraints. See *id.* (explaining complex process of trial and error when breeding profitable bloodlines of race horses).

75. For example, Smarty Jones, recent Kentucky Derby winner, was owned by the late Roy Chapman, who, before the success of his underdog race horse, was probably better known for owning the chain of successful Philadelphia-area car dealerships that bears his name. *The Smarty Jones Story*, HORSE-RACES.NET, Feb. 12, 2006, <http://www.horse-races.net/library/article-smarty.htm>. Developing Smarty Jones' race abilities required several years of complex training, strategy, and specialized attention, including veterinary hospitalization for injuries that almost ended the horse's race career before it started. *Id.*

breeding would seem best typified as a section 212 investment activity.⁷⁶ On the other hand, farming generally would seem to be a section 162 full-time business, with owners less likely to have income from other sources to offset losses from section 183 agricultural operations. In an effort to provide a basis to apply the new statute, experts in the fields of cattle ranching and horse breeding were hired to educate IRS officials.⁷⁷ The presumption's specific mention of horse breeding was enacted pursuant to specifically researched tax theory that supported applying section 183 to the activity while also offering taxpayers an incentive to invest.⁷⁸

The legislative history suggests that Congress enacted the presumption to protect individual taxpayers involved in farming activities.⁷⁹ The Senate Finance Committee apparently concluded that poor farmers would be harmed by the tougher standards enacted under the 1969 Tax Reform Act ("1969 Act").⁸⁰ Although the intent and financial viability of horse breeders may differ greatly from indigent farm-owners, horse breeding was still included and enhanced by the section 183(d) provision.⁸¹ The Senate Finance Committee

76. Section 212 is not limited to expenses related to income-producing property; rather, it includes any expenses incurred for the production of income. *See* I.R.C. § 212 (2000).

77. Condon, *supra* note 66, at 718.

78. "This is an important industry in my State and in other States. The commercial horse industry as a whole has an investment of over \$2 billion in the United States. It pays, I think, something like one-half billion dollars in taxes." 115 CONG. REC. 28, 38296 (quoting Senator Cooper, the horse breeding amendment petitioner). The Senator explained that the amendment was based on the impossibility that those engaged in horse breeding would produce a profit in two out of five taxable years. *Id.*

79. *Id.* at 38295 ("The purpose of the amendment is to allow a reasonable time for activities having a long cycle of investment and a recognized element of risk, such as thoroughbred breeding and training, to meet the test required by the Committee bill."); *see also* Condon, *supra* note 66, at 718 (quoting an IRS news release referencing the creation of advisory committee for horse breeding industry to assist the Senate Finance Committee in implementing 1969 amendments).

80. Treasury Department regulations provide the following illustrative example:

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.

Treas. Reg. § 1.183-2(c) example 1 (1986).

81. Deborah M. Paris & Kent D. Schenkel, *Equine Endeavors: Hobby vs. Business*, FLA. BAR J., Mar. 1989, at 33, 33 ("Investment and participation in the horse world carries with it an aura of excitement, glamour and sophistication.").

adopted the amendment and granted the Commissioner's request for an advisory committee to assist in implementing the 1969 Act.⁸² Section 183 of the Code was enacted specifically to provide favorable tax treatment for individual activities that otherwise failed under the Code's rigid trade or business standard.⁸³

It is not entirely beyond the realm of reason to believe Congress could invest time and resources to create a solution with similar provisions that alleviates both the problem of online anonymous tax avoidance and the burden put on legitimate taxpayers that participate in e-commerce and use Internet auction sites for business, secondary income, or hobby purposes.⁸⁴ The statutory revisions made under the 1969 Act sought to prohibit offsetting taxable income against losses from hobby activities while at the same time preventing harsher treatment of susceptible profit-making activities, such as horse breeding. Similarly, the current Code should be altered to curb the abusive tactics employed when taxpayers use eBay to produce substantial income and fail to report it.⁸⁵ At the same time, the Code should also reflect the core values of using eBay and seek to prevent any detrimental effects on its proliferating use.⁸⁶ The IRS should seek a better understanding of the nature of eBay transactions to ensure that new regulations and expert advice would not only enable the agency to combat compliance failures, but also provide less interference and offer better tax consequences to users who are hindered by the current Code application.

The federal government's failure to recognize the significance of under-reported income derived from using Internet auction sites has likely contributed substantially to the current tax gap. Congress has elected to take a "hands-off" approach regarding the regulation of Internet sales, exemplified by its moratorium on the implementation of any use or sales tax.⁸⁷ Several

82. See 115 CONG. REC. 28, 38297.

83. See I.R.C. § 183 (2000).

84. See Condon, *supra* note 66, at 718 (discussing the use of expert analysis and government resources for application of section 183's provisions).

85. Mary Dalrymple, *IRS May Label eBay as Taxable Income*, ASSOCIATED PRESS, Mar. 27, 2005, available at http://articles.news.aol.com/business/_a/irs-may-label-ebay-sales-astaxable/2005032713080999001 ("An eBay survey last year found that 430,000 of its U.S. sellers make a significant portion or all of their revenue from selling on eBay."). Dalrymple quotes one eBay user recounting a presumably typical conversation encapsulating misperception about income derived from eBay: "I talked to a friend of mine who does eBay, and she's not filing because she said it's not regulated." *Id.*

86. The explosion of Internet auction sites is clearly productive for our nation's economy, despite the problems discussed in this article, but the ramifications created by its anonymity has left the rest of the tax base to pay for the income hidden from the IRS. Those who have exploited eBay to gain a tax advantage have created an inequity in the current tax system; the rest of us must bear the burden, so that the few may escape tax liability.

87. Internet Tax Freedom Act, Pub. L. No. 105-277, sec. 1101, 112 Stat. 2681-719 (1998).

states have followed suit by enacting statutes and amending current provisions to effectively bar any taxation on sales derived from e-commerce.⁸⁸

D. Hands Off: E-Commerce Has Free Reign to Flourish, But at What Cost to Taxpayers?

The debate over how to handle e-commerce regulation continues today. Under the Commerce Clause of the United States Constitution, the power to regulate interstate commerce is reserved specifically to Congress.⁸⁹ Though unimaginable to the Founders, the issue of whether the federal government should regulate e-commerce has become a hot topic in recent litigation. Unfortunately, instead of spearheading regulation of online business, the federal government has reserved implementation of any type of regulatory scheme.⁹⁰ The Supreme Court, in a decision involving mail order sales, appears to have accepted Congress' ideology and has found a legal basis upon which to apply it.⁹¹ The federal government willingly relinquished control over e-commerce, and the Supreme Court solidified this position by tying states' taxing hands.

The government's approach has properly prevented interference with the proliferation of e-commerce, but risks suggesting to individual taxpayers that income from eBay activities creates absolutely no tax consequences.⁹² Companies like eBay have compounded the problem by refusing to provide assistance with tax issues regarding usage of their auction services.⁹³

In reality, as Professor James Edward Maule asserts, taxpayers still have the same obligation to pay income tax, but they have been offered little guidance

88. See Frey et al., *supra* note 28, at 27.

89. U.S. CONST. art. I, § 8, cl. 3.

90. Under the Clinton administration, the White House's official position was to prevent the addition of any new forms of special taxes on Internet-based transactions, based upon the "concern[] about possible moves by state and local tax authorities to target electronic commerce and Internet access." James P. Kratochvill et al., *Sales and Use Taxes: Communications Services and Electronic Commerce*, Tax Mgm't Multistate Tax Portfolios (BNA), § 1350.13.D (2005) (citations omitted).

91. In *Quill Corp. v. North Dakota ex rel. Heitkamp*, the Court maintained that states, as well as local municipalities, may not under any circumstances impose any sales or use tax upon a business located outside of the state, unless such business has a "physical presence" within the state's borders. 504 U.S. 298, 311, 317 (1992); see also *Nat'l Bellas Hess, Inc. v. Dep't of Revenue*, 386 U.S. 753, 756 (1967). Writing for the majority, Justice Stevens reasoned that a possible conflict with the Commerce Clause would emerge if states were allowed to impose use tax upon businesses located outside of the state attempting the imposition. *Quill Corp.*, 504 U.S. at 305. Essentially, states are left with no recourse to tax e-commerce because of the nature of the Internet and its interstate implications.

92. See generally Dalrymple, *supra* note 85 (describing varying viewpoints of public regarding tax implication of eBay use).

93. eBay estimated that 430,000 mom and pop sellers, who spend less than 20 hours per week selling, may have accounted for as much as 95% of the \$24 billion in gross sales traded on eBay last year. Sowa, *supra* note 4.

on how to approach the subject and often times follow poor advice.⁹⁴ Since the dawn of the modern tax age, income has been defined as any “accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”⁹⁵ Therefore, individuals must report any gain derived from the sale of items on eBay.⁹⁶

94. Maule, *supra* note 47. Professor Maule has suggested that

[i]t may be time to begin collecting Tax Urban Legends. It's not so much the quantity, but the quality of the misinformation. . . . I found myself reading an AP story [Dalrymple's article] about the taxation of income earned through selling items on eBay. . . . A woman who sells household items wanted to know if she was required to report her income for federal income tax purposes. Somehow she ended up unable to get a clear answer. Perhaps it's because she posted her question to an online discussion forum operated by eBay for its sellers.

Id. Professor Maule continued by clearing up much of the confusion that curious users may have on the subject, but perhaps oversimplified the complexity of intent and profit motive when dealing with the section 162/183 dichotomy. *See id.* Tax consequences when using eBay, especially when users are not sure whether they are posting items as a hobby or cultivating such activities into a profitable venture, may not be sorted out because eBay conveniently deletes their user records, which occurs every 30 days. Rosenberg, *supra* note 37. Professor Maule does, however, comment later that eBay's refusal to cooperate with explaining and documenting user tax liability is “unsettling.” Maule, *supra* note 47.

95. *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

96. Section 1001(a) of the Code provides:

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

I.R.C. § 1001(a). The sale of a personal item for less than it was originally purchased is not included in this definition, but if the highest bidder purchases the product for more than its original purchase price (maybe for some inherent sentimental value the items holds), then such a gain may be subject to capital gains rules, which are beyond the scope of this article. *See* I.R.C. § 1011 (2000).

III. INTERNATIONAL SOLUTIONS TO SOLVE THE E-COMMERCE ANONYMITY PROBLEM

A. The Promising Results Overseas

Although the IRS has promulgated several tactics to combat the tax gap,⁹⁷ the agency seems to have failed to acknowledge eBay users and the current hands-off approach regarding e-commerce as a potentially significant source of the problem. Currently, several foreign nations have taken promising steps in understanding and combating abuse of e-commerce. In the United Kingdom, the Revenue Department has recently developed a program specifically engineered to discover anonymous users who post and sell items on eBay but fail to claim such income on their tax returns.⁹⁸ In Australia, the government has acknowledged the anonymity problem posed by the Internet and determined that approximately 15% of Internet businesses with supposed physical locations within the country were impossible to locate.⁹⁹

New Zealand has also taken affirmative steps to combat e-commerce-based tax evasion by imposing information reporting requirements on Internet-based businesses.¹⁰⁰ As early as 1996, the IRS hinted that federal tax laws would be unable to cope with the technology involved in Internet sales, yet nearly a decade later no further action has been taken.¹⁰¹ Professor Arthur Cockfield,

97. The most crucial area that may see legislative change in the upcoming year is in expansion of third-party reporting requirements, which the IRS has recently contemplated, although not in connection with auction site operators. See Internal Revenue Serv., *IRS Updates Tax Gap Estimates* (Feb. 14, 2006), <http://www.irs.gov/newsroom/article/0,,id=154496,00.html>. If the IRS is willing to require credit card companies and other financial institutions to report certain types of transactions, then it may be just as reasonable to require eBay and others to report the transactions for which they provide the “platform” in much the same manner credit card companies provide an electronic platform for every type of transaction imaginable.

98. Revenue and Customs, the United Kingdom’s IRS equivalent, has unleashed a highly advanced search engine dubbed “the web robot” to track high-volume users who fail to report income derived from the sale of items through eBay. *Tax Man Warning to eBay Traders*, STAR, Aug. 21, 2006. Revenue and Customs decided to develop this £250,000 program based on the sky-rocketing volume of e-commerce transactions and increasing use of eBay trading to supplement income, and expected to recoup nearly £1,000,000 in unpaid taxes in its first year of use. *Id.*

99. In one instance, the Australian investigators conducting the search “literally came across a hole in the ground where the business was supposed to be conducting its operations.” Arthur J. Cockfield, *Designing Tax Policy for the Digital Biosphere: How the Internet Is Changing Tax Laws*, 34 CONN. L. REV. 333, 345 (2002) (citation omitted).

100. Much in tune with the efforts of Australian tax authorities, New Zealand requires Internet-based businesses with online sales over \$40,000 a year to submit tax information to a national registry to combat reporting failures. N.Z. Inland Revenue, *Online Trading* (July 24, 2006), <http://www.ird.govt.nz/ecommerce-tax/onlinetrading.html>.

101. “From a certain perspective, electronic commerce doesn’t seem to occur in any physical location but instead takes place in a nebulous world of ‘cyberspace.’ Persons engaged

writing on Internet tax law, argues for a more realistic approach to combating Internet sales tax fraud¹⁰² and warns that traditional tax law is not flexible enough to apply to what he calls “the digital biosphere.”¹⁰³ Whether the solution requires a rethinking of traditional values or the establishment of more stringent protocols to combat tax evasion, it appears that the IRS is simply unprepared to combat fraud in the virtual world and is hindered by Congress’s moratorium on Internet taxation.

B. The IRS Position on the Home Front

The IRS recently announced plans to increase its enforcement budget in an attempt to more diligently audit tax returns by hiring more field auditors.¹⁰⁴ In addition, the IRS posted guidelines on its website to provide auditors with a better understanding of how to investigate e-commerce tax evasion.¹⁰⁵ However, these measures simply do not address the overarching problem: if eBay users can remain anonymous,¹⁰⁶ then no record of transactions identifying the taxpayer are available to assist IRS enforcement efforts. To fully understand the nature of eBay users, it is necessary to separate those users into categories, as discussed in the next section.

in electronic commerce could be located anywhere in the world and their customers will be ignorant of, or indifferent to, their location.” Cockfield, *supra* note 99, at 338 (quoting OFF. OF TAX POL’Y U.S. DEP’T OF TREASURY, SELECTED TAX POLICY IMPLICATIONS OF GLOBAL ELECTRONIC COMMERCE 25 (Nov. 1996)).

102. Professor Cockfield suggests that the goal of tax law is to protect social norms and practices regarding taxation of income producing activities, but notes the Internet has spurred what he labels the “digital biosphere,” which is essentially the interaction of cyberspace with the reality we live. Cockfield, *supra* note 99, at 334, 353-55. He argues that current tax systems, including the United States’, are far too rigid to regulate e-commerce, which has gained popularity because it is so flexible and not confined by the natural borders of space or time. *Id.* at 338-39.

103. *See id.* at 362-63.

104. *See* Internal Revenue Serv., *IRS Updates Tax Gap Estimates*, *supra* note 97; Tumey, *supra* note 1.

105. *See* INTERNAL REVENUE SERV., RETAIL INDUSTRY AUDIT TECHNIQUE GUIDE 3-2, 3-3 (2005), available at <http://irs.gov/businesses/small/article/0,,id=141491,00.html> (discussing interviewing techniques, Internet usage, and software application assistance).

106. *See* Cockfield, *supra* note 99, at 343-45. Websites like Anonymizer allow eBay users to mask their IP to prevent tracking by third parties, and eBay does not verify user information. *See* Anonymizer, <http://www.anonymizer.com>. Therefore, all that is needed is a fake email address and a masked IP address to ensure the IRS will not track sales on the company’s site. Cockfield, *supra* note 99, at 344-45 n.56.

IV. THE HYPOTHETICAL EBAY USER MAP

A. User Categories: The Businessperson, the Income Supplementer, and the Hobby Enthusiast

The flea market and yard sale bargain-hunters are not the only type of users that have flocked to the eBay marketplace.¹⁰⁷ Many utilize eBay to sell products traditionally found in neighborhood stores because the costs of maintaining a business online are far cheaper than the expenses related to establishing a physical storefront.¹⁰⁸ Still other users hold primary employment elsewhere but buy and sell on eBay as a hobby or a secondary source of income. The IRS should not waste funding to audit users who passively enjoy the use of eBay, but instead should focus on educating such users on the tax implications involved *if* they were to make a profit from their eBay transactions.¹⁰⁹ For example, a buyer in the market to purchase a used Fender Stratocaster guitar could find a plethora of users who have posted such an item for bidding. The overwhelming majority of these sellers are likely to be typical eBay enthusiasts selling a guitar purchased for full retail value which they subsequently lost interest in playing or rendered obsolete by upgrading their equipment.¹¹⁰ Consider one such hypothetical seller, Steve from Witchita, Kansas, who was recently kicked out of his band for showing up late to practice on several occasions.

On the other hand, there will be a small yet significant number of sellers who warehouse a large number of guitars and accessories and post these products, both new and used, for bidding.¹¹¹ The fictitious Rick Rift will stand in for this category of sellers. Rick Rift is a sole proprietor who has chosen to risk failing to report income from his business, Rick Rift's Guitars. For the sake of the hypothetical, he specializes in purchasing Fender guitars in bulk for pennies on the dollar; he is able to undersell the product, especially if he is not paying tax on the income. Rick Rift will represent the population of eBay users who purposely do not report income from lucrative online business

107. See Dalrymple, *supra* note 85 (noting an estimated 430,000 American users derive significant or all a significant portion of their income from using eBay).

108. The number of consumers reached is far greater as well. In addition, many maintain stores and sell online to supplement the income derived from their physical storefronts. See Sowa, *supra* note 4.

109. Compliance is crucial to any tax system, and the IRS should simplify the consequences of using eBay, or at least map out a more comprehensive mechanism so that hobby enthusiasts do not have to pay tax professionals to find the correct answer.

110. These sellers just want to recoup value they lost. Therefore, there is no accession to wealth or capital gain if the bidding falls short of their original purchase price. See I.R.C. §§ 61, 1001 (2000).

111. Without naming specific eBay users or commenting on whether they report their income appropriately, a simple eBay search by typing in the word "Stratocaster" will most likely retrieve many similar users offering such a guitar and many more available for bidding.

sales, which would otherwise qualify for trade or business expense deductions or hobby losses.

Obviously, there are far different tax consequences for the seller if a taxpayer purchased a new Fender from Rick Rift's Guitars' online inventory rather than from Steve. Steve most likely will not have to report any income on his tax return if the winner of his auction does not bid more than retail value for his used guitar.¹¹² However, Rick Rift is probably making substantial profits from his sales, yet he is under little threat of IRS enforcement if he uses an IP address blocker.¹¹³

Next, consider the scenario of a taxpayer who is in the market to sell an acoustic guitar she purchased on impulse a year ago. The taxpayer purchased the guitar for \$80 and posts a minimum bid of \$20. If she uses eBay to post the item for bidding, the taxpayer will first have to pay a small fee to list the item. Then, the taxpayer must choose how long she wishes to leave the bidding floor open. There is a high probability that soon after someone successfully bids on the guitar, eBay may actually delete any record of the transaction from her user account. Therefore, if for some reason she actually sells the guitar at a gain (i.e., for more than the original purchase price), she will have no opportunity to maintain an adequate record of the transaction unless she keeps a personal record of it.¹¹⁴ If the taxpayer did not expect to make a profit, or, for example, if she posted hundreds of items for bidding simultaneously, she will not know what tax consequences may arise until all sales are complete.

If the taxpayer believes what she is doing is just a hobby and she is getting rid of "junk" that she does not want or expect to profit from, then most likely the taxpayer will not keep her own records. If she does make a substantial profit and eBay deletes all records of the transactions, the taxpayer may be inclined to pocket the income instead of making a potentially inaccurate assessment of the gains for tax purposes.

The best solution is to allow a longer period of time for users to assess which category they fit. The IRS should maintain the presumption that would persuade users to comply in order to achieve beneficial tax treatment under

112. The amount realized from the sale would be less than the basis of the guitar when originally purchased. *See* I.R.C. § 1001.

113. As Professor Cockfield points out, websites like anonymizer.com market a product that can prevent both hackers and third parties from tracking a user's IP address when using eBay. Cockfield, *supra* note 99, at 344-45 n.56. "[T]he network—as it is currently constituted—makes it possible for Internet users to be shrouded in anonymity in many circumstances." *Id.* at 343. Of course, the availability of anonymity in no way affects a user's obligation to report taxable gains.

114. Users can receive and maintain e-mailed records from eBay, and both eBay and third-party companies currently offer software to track sales; however, the software is usually fee-based and a user who does not know the tax consequences of her eBay activities in advance may not start tracking sales until after records of taxable transactions have already been deleted by eBay.

section 183. eBay should then be required to maintain records for a significant time period to assist its average users with record-keeping and determining the category into which they fit—trade or business, activity entered into for profit, or hobby.

In another example, Louie, a stay-at-home father of three, supplements his wife's income by selling various items on eBay. He set up an office, purchased a digital camera, spent significant income on Internet tools and equipment, and invested several hours of time cultivating his hobby. Louie has no experience marketing products online or keeping business records for an Internet-based business, but he recently closed down his failing brick-and-mortar comic store so that his wife could return to her full-time employment. Louie never intended to engage in online selling as a full-time business venture, but he found a wider audience than he expected for his eBay sales.

After little success in the first few months, Louie honed his eBay skills and found a niche market for the stacks of *Supernerd*¹¹⁵ comics he was unable to sell at his failed comic store. Louie believed that the IRS would never discover his activities and opted not to report his income. He continuously withdrew money from the PayPal account which received the profits from his eBay sales by making online purchases to hide the flow of income. The only information he submitted to eBay when registering was a rarely used, anonymous e-mail address he kept for several years. This scenario is the most difficult for the IRS to track. If Louie was required to submit IRS Form W-9¹¹⁶ information to customers to qualify as a vendor on eBay, or if an IRS Form 1099¹¹⁷ was automatically issued for purchases over \$600,¹¹⁸ the IRS would be in a much better position to track such sales. Moreover, Louie might think twice about trying to avoid reporting his income.

As for the other examples, the most successful way to prevent Mr. Rift from exploiting e-commerce and the Code is to correct the problem at its source. The "eBay Marketplace" is an anonymous haven for tax dodgers and is a proven source of confusion for legitimate users who simply are unaware that they must pay taxes on income earned from auction sales. The federal government should require eBay to increase its registration and record keeping

115. As far as I know, this is a hypothetical comic.

116. Currently, it is the customer's responsibility to report income paid to the seller, but this reporting might be impossible if the vendor cannot be traced (i.e., the seller does not have a tax identification number). See I.R.C. § 6041(d) (2000). The use of the W-9 form would prevent the failure to trace anonymous users.

117. Income derived from eBay activities is best typified as "other income." See I.R.C. § 61; Internal Revenue Serv., Form 1099-MISC: Miscellaneous Income, available at <http://www.irs.gov/pub/irs-pdf/f1099misc.pdf>.

118. For this hypothetical, half of Louie's sales were over this amount and the first edition copy of *Supernerd* No. 1 sold for over \$2,000.

protocol. To gain access, every eBay user should have to register not only his or her IP address but also a physical address to their user account.¹¹⁹

This possible solution is not without precedent. Currently, the IRS requires vendors who make sales of over \$600 annually to file an IRS Form W-9 and register for a tax identification number, which allows purchasers to report the amount paid to the vendor.¹²⁰ In addition, the IRS should promulgate a rule that requires Internet auction sites to issue an IRS Form 1099 for every user annually.¹²¹ The present system places the reporting burden on the purchaser, even though it is the seller who derived taxable income from the transaction.¹²² This solution would enable bona fide users to comply with federal income tax requirements, weed out those anonymous users who exploit the system, and avoid any complications for hobby users who make total annual sales less than \$600.

B. Results Under the Current System If the Proper Changes Were Made

As part of a new approach to remedying the tax gap, auction sites should be required to maintain transaction records for at least one to two years, and should provide access to such records so that individuals and the IRS can more accurately account for such earnings. Obviously, the entire burden should not be placed on auction sites like eBay. Therefore, the IRS should invest its increased budget on an e-commerce education project rather than auditing.¹²³

Furthermore, the IRS should take a friendlier approach to promoting compliance by educating individual taxpayers, perhaps by providing a website that specifically explains the tax implications of eBay-type activities that could

119. This would also benefit eBay by reducing the risk of user fraud and increasing the accountability of its users. If this approach proves too harsh or presents significant countervailing privacy concerns, then the IRS could only require users with specified number of sales annually to register as an "eBay online business."

120. See I.R.C. § 6041 (2000) (requiring IRS tax identification number for vendors).

121. Congress has debated the possibility, but has yet to decide the issue. See *Service Eyeing Crackdown on Online Tax Scofflaws*, KIPLINGER TAX LETTER (Kiplinger Wash. Editors Inc., Wash., DC), Sept. 8, 2006. See also Mike Batsimm, *Taxes - Part One: Do I Have to Report My Auction Earnings?*, AUCTIONBYTES, Mar. 4, 2001, <http://www.auctionbytes.com/cab/abu/y201/m03/abu0033/s03> ("A Form 1099 is used by a purchaser of a product or service to report to the IRS and the seller that a transaction has taken place. . . . [S]omeone who pays more than \$600 for products or services over the course of the year is supposed to send a 1099 to the seller.").

122. See I.R.C. § 6041 (2000).

123. See Internal Revenue Serv., *IRS Updates Tax Gap Estimates*, *supra* note 97. Auditing may hinder individuals who probably have not violated the law because they have actually filed a return, while an educational campaign is better suited to the technology age. In addition, the current eBay problem involves anonymous users who do not file returns in the first place, so auditing may never catch this group of users. See Cockfield, *supra* note 99, at 344-45.

be linked on eBay and other auction sites.¹²⁴ A similar approach was used in 1969 with regard to the new rule providing a presumption of profit motive to horse breeders, where investments were made in expert analysis of the rule's application.¹²⁵ The IRS should apply section 183 to provide the same presumption of profit-motive to individual auction site sellers. Those who incur legitimate expenses in cultivating their eBay fascination should be allowed to deduct such expenses, even if they do not profit substantially from eBay sales.¹²⁶ This also would allow Steve (the failed musician from the hypothetical) to deduct the loss from the sale of his guitar if he actively uses eBay to profit from the sale of other personal property, even if his activity would not qualify as a trade or business under section 162.¹²⁷ Casual users may be persuaded to keep diligent business records to benefit from deductions on items sold for a loss, and the IRS would benefit from the increased compliance without having to expend resources on small-time sellers.

Code section 1001 also plays an important role for auction site users who are looking to sell capital assets of considerable value, rather than used personal property.¹²⁸ Many users are currently employed full time in other areas, but still invest significant time and money on eBay activities.¹²⁹ This type of user would receive the most benefit from the section 183 presumption. Initially, what may begin as a fun hobby may flourish into a lucrative secondary source of income, so profits may not accumulate during the early years when a casual user rarely sells items. This is especially true for the failing store owner (like Louie) who closes his physical storefront for lack of interest, only to flourish selling the same goods through eBay several years later.

124. The IRS should employ e-commerce professionals familiar with the intricacy of using eBay to provide this information. They could help explain how the site works and determine the profiles of the various forms of users currently trading on eBay.

125. *See supra* Part II.C.

126. Individual users may not deduct expenses that must be capitalized and deducted over time, but may deduct one-time expenses that are currently deductible and are ordinary and necessary in carrying on eBay activities as a business. *See* I.R.C. § 162 (2000).

127. *See, e.g.,* *Portland Golf Club v. Comm'r*, 497 U.S. 154, 168-71 (1990).

128. Consider, for example, a man selling several basic items on eBay, including a painting which he bought at a garage sale a year earlier, when

after 94 offers, bidding for the painting—which on a computer screen looks vaguely like a landscape swathed in red, orange and a pinkish accent—had soared to \$135,805. The run-up was fueled by speculation that it may be a 1952 work by Richard Diebenkorn, the late California painter known for his sublime use of color in abstract and representational works.

Judith H. Dobrzynski, *eBay Art Auction May or May not be Modern Classic*, N.Y. TIMES ON THE WEB, May 9, 2000, <http://partners.nytimes.com/library/tech/00/05/biztech/articles/09ebay>. Although the sales recounted in Dobrzynski's article were actually part of one of eBay's more famous scams, the rapidly escalating bids highlight the presence of a very active market for big-ticket items on eBay.

129. Sowa, *supra* note 4.

C. The Results Analyzed

This section applies the current Code provisions to the hypothetical situations posed earlier. Taxpayers should be aware of the income they derive from eBay under the current system.¹³⁰ Failing to adequately report earnings may result in serious financial penalties, or possibly criminal prosecution. In addition, if a dispute does arise, taxpayers should be aware of their legal choices if they decide to challenge.¹³¹

In the hypothetical situations, all three types of eBay users were present: (i) Steve, the failed musician selling personal property, (ii) Rick Rift, the tax-dodging businessman, and (iii) Louie, the successful part-time comic vendor. Under Code section 162, neither Steve's nor Louie's activities are likely to rise to the level of a trade or business, and therefore, they will not be able to deduct their expenses thereunder. However, it is likely that Rick Rift is involved in a trade or business under section 162.¹³² Rift may elect to take a Schedule C deduction for any ordinary and necessary expenses related to his business of selling guitars through eBay.¹³³ In the hypothetical, he does not report any income, so he may not take advantage of this deduction unless a change in regulation is put forth by the IRS over eBay to force compliance. Third-party reporting may alleviate the failure to report and make compliance easier for taxpayers involved in similar activities.

Steve likely has no tax consequences if he sells his guitar for less than originally purchased; thus, neither Code section 162 or 183 will apply in his situation.¹³⁴ He made a one-time sale and derived no reportable income or capital gain.¹³⁵ Therefore, the IRS has little basis to enforce an action, but should seek to ensure that any regulation of eBay activities will not adversely affect Steve's use of the trading platform. As for Louie, the section 183

130. If the IRS actually discovers that an individual may have had unreported income from using eBay, it may seek to enforce an action against the individual.

131. The individual essentially has two options: pay the assessment and challenge the determination after the fact as an overpayment in either the United States District Court where the potential tax liability arose or United States Court of Federal Claims, or refuse to pay and challenge the determination presently in the United States Tax Court. DAVID M. HUDSON & STEPHEN A. LIND, *FEDERAL INCOME TAXATION* 424 (10th ed. 2007).

132. "The proper test is not the reasonableness of the taxpayer's belief that a profit will be realized, but whether it is entered into and carried on in good faith and for the purpose of making a profit, or in the belief that a profit can be realized thereon, and that it is not conducted merely for pleasure, exhibition, or social diversion." *Doggett v. Burnet*, 65 F.2d 191, 194 (D.C. Cir. 1933). Clearly, Mr. Rift spends significant time on his business venture, and selling wares on such a large scale is not typically done for mere fun, but rather to make a profit.

133. *See* I.R.C. § 162(a) (2000).

134. He lost his band gig, and thus no trade or business exists. He is making a one-time sale with no expectation of profit, but rather a hope of recouping the loss on his investment.

135. Obviously, if he had recognized a gain on the transaction, then he would be required to report.

presumption would be beneficial, but if he relies on his user account to track his business records and eBay deletes the relevant information, he could be left with possible inaccuracies on his tax return. It is difficult to say for sure whether his use of eBay to generate supplemental income would be viewed by the IRS as a trade or business.¹³⁶ Most likely it would qualify for the section 183 hobby loss provisions and allow him to deduct any reasonable expenses if he could show a profit motive.¹³⁷ The IRS will find an enforcement problem here if he does not reported his income, and had Louie opted to report his income, he would be unable to ascertain whether he could show profit motive to enjoy the application of expense deductions under section 183. Taxpayers should not rely on eBay to keep records; rather, the safest option would be to personally maintain records of sales. This could potentially serve as evidence of profit motive and will, more importantly, provide the ability to report accurately on tax returns.

V. CONCLUSION

Congress and the IRS need more insight into the use of e-commerce, and current tactics employed by the IRS should be updated to reflect the change in social norms and technological advancement. Failure to do so will only lead to an increased tax gap and a heavier burden on the majority of the tax base who honestly report income and pay the requisite taxes. E-commerce has emerged as an integral function of modern business practice, yet the Code has not been modified to reflect this change. Therefore, online businesses, as well as individual vendors and purchasers, are able to avoid most applicable regulations and federal income taxation requirements with little risk of getting caught.

There are several simple solutions to the current problem, but it appears that our elected officials and appointed members of the Treasury Department are not thinking ahead of the curve to combat the loopholes technology created for online transactions. IRS Forms W-9 and 1099 should be a standard requirement for those conducting activities for profit on sites like

136. While Louie may be holding himself out as engaged in a trade or business, this is a fact-by-fact determination with a presumption in favor of the IRS's initial determination of the activities. *See Weber v. Kavanagh*, 52 F. Supp. 619, 624 (E.D. Mich. 1943); *see also Helvering v. Highland*, 124 F.2d 556, 561 (4th Cir. 1942) (to constitute a trade or business, activity must be represented as such to others).

137. The courts hold that a failure to keep business records is a possible ground for finding that no profit motive exists. *See, e.g., Burrhus v. Comm'r*, 52 T.C.M. (CCH) 447, 450 (1986) (holding that "petitioners failed to keep proper records with respect to all of such activities. . . [and] the activities were obviously not conducted in a businesslike manner."). *But see* Treas. Reg. § 1.183-2(b)(1) (1986) (whether the taxpayer "maintains complete and accurate books and records may indicate that the activity is engaged in for profit."). However, if the belief is that a profit may be accomplished, even if that belief proves unreasonable, related expenses may be deductible. *Fox v. Comm'r*, 80 T.C. 972, 1006 (1983).

eBay. In addition, both eBay and its users should be held responsible for the current problem they created. Although the IRS should offer more assistance to users and eBay in carrying out their responsibilities, the agency can only be stretched so far. Online traders should be more aware of their legal responsibility to pay taxes on income derived from such sales, and eBay Inc. should uphold its corporate and social responsibilities by combating the problem. eBay claims it has no responsibility because it is merely the trading platform, but that does not negate the fact that it derives income from each and every transaction. For this reason, it should be regulated and forced to assist the IRS in combating the current tax gap arising from such unreported activity. Hopefully, the law will soon catch up with technology, but until such change occurs, eBay users will continue to sidestep federal income tax reporting requirements and benefit from the burden the rest of us share.