The Tax Lawyer

Ten Tips For Deducting Your 'Hobby'

Robert W. Wood, 01.08.10, 7:20 PM ET

Will the IRS pay for your hobby? The short answer is: No. But the more nuanced answer is: "Yes, Uncle Sam will sometimes subsidize your hobby." If, that is, you make it into enough of a real business.

If you want to avoid any IRS hassles, my standard advice is to keep business and personal pursuits purely separate.

But that doesn't work for everyone. We live in a multipurposing culture. When we travel for business, we try to make it a vacation, too, by tacking on extra days at the end or squeezing in some golf or sightseeing between meetings. When we buy a new car, we want it to handle both family trips and office commutes. Today's economic and time demands make multipurposing even more compelling.

Moreover, *Do What You Love, The Money Will Follow*, isn't just the title of a classic self-help book by psychologist Marsha Sinetar: It's a way of life, and a much talked about one these day. Guy Kawasaki lectures about it, and many others write, blog, speak and even proselytize it.

What does all that have to do with tax law? It raises the question: If you are passionate about something you do, can you treat it as a business on your tax returns?

This is not an idle question. If you lose $20,000 a year in the "business" of breeding, training and caring for whippets, then you can report that loss on a Schedule C and write if off against your salary on your Form 1040. Assuming your combined state and federal income tax rate is 40%, your whippet breeding will really only cost you $12,000, and Uncle Sam and your state will have subsidized your passion.

But you can only write off that loss if you are in the business of breeding--meaning the IRS believes you're in it to make a profit. If your whippets are a hobby, you can't claim a loss from breeding. You must still report any income from whippet sales, but you can only deduct your expenses from whippet breeding to the extent of those sales. Moreover those expenses must be claimed as miscellaneous itemized deductions, usable only to the extent they exceed 2% of your adjusted gross income.

Before you decide to turn your nondeductible hobby into a deductible business, be aware that this is an area of intense scrutiny by the IRS--so much so that last year it issued a new manual to help its agents ferret out taxpayers improperly writing off the costs of hobbies.

With that said, here are 10 tips for getting a more favorable business tax treatment for a pursuit you enjoy.

1. Match income and loss.

The IRS is unlikely to question whether you're engaged in a business if your income from an activity exceeds your expenses. If you make $20,000 breeding, showing and selling whippets but offset it with $20,000 of expenses, you net out at zero. You're still deducting all your expenses, but you're not offsetting them against other income--say, your salary or income from a medical practice. That makes the IRS less likely to complain.

2. Keep good records.

It matters whether you conduct yourself in a businesslike manner. If you keep good records, hold yourself out as running a business, etc.--that will help, no matter how unsuccessful you are at making a profit. Good record keeping is particularly important.

3. Show a profit three years in five.

If you can manage to eke out a profit three years out of every five (or two years out of seven, if your activity is horse breeding), the IRS will presume you're in business to make a profit. That presumption is worth a lot since you probably won't have to mud wrestle with the IRS over a more amorphous "facts and circumstances test" that looks at all the details of how you conduct your hobby/business. In fact, if you meet this presumption, the IRS can still argue that your activity is not engaged in for profit, but the burden shifts to the IRS to prove that the activity is not engaged in for profit. There have been tax cases where taxpayers have beat the IRS in court even though they made a profit only once in 10 or 15 years. But those are tough cases.

4. Plan income and expenses.

Our tax system is annual, and so are profit-and-loss determinations. You may have more control than you think over when you receive income and especially when you incur expenses. That control can help you make a profit three years out of five. You can legitimately bunch expenses by, for example, buying all your equipment in one year, rather than spreading your purchases over two, or by going to more whippet shows in one year than the other. You're less likely to be able to legitimately time your income, but you can sometimes time big payments by delaying sending an invoice, etc. (See "When You Have Income But No Cash.")

5. Delay a profits determination.

A special tax rule allows you to elect to defer the determination of profit motive until the fourth year of your "business," or sixth year in the case of an activity involving horses. To make this election you file a Form 5213, thereby postponing the determination of whether you've met the three-out-of-five-years profit presumption. The idea of the election is to give you time to ramp up and achieve a profit.

Warning: Most advisers don't recommend making this election. Why? It seems to invite audit by flagging the profit-motive issue. Plus, it has the effect of extending the IRS statute of limitations beyond the normal three years, so the IRS can examine all the years in question after the deferral period has passed. (For more about the IRS statute of limitations, click here.)

6. Do it full-time.

Most of the time the IRS goes after a taxpayer who writes off his or her "hobby" against other income from a regular job. If you work 40 hours a week in an office and raise chinchillas on the side, does that mean you have no profit motive and chinchillas are just a hobby? No, you can still have a business that is part-time. In fact, you can have multiple part-time businesses. Nevertheless, the IRS is more likely to consider an activity a business if you do it full-time.

7. Write a business plan.

This may sound silly, but the IRS looks for businesslike activity. One of the auditors' checklist items is a business plan. Write one up, whether or not you stick to it. Revise it periodically. Try to look business-like in all things. For example, the plan might include project goals, start-up costs, advertising, projected results, and parameters for discontinuing an unsuccessful venture.

8. Hire experts and become one.

The more expert you become in a field, and the more you engage other experts, the more business-like you'll look. If you have advanced degrees or otherwise have expertise in the activity, it looks less hobby-like. (If you don't have a degree, but do extensive research on an area, keep records of that research to prove the time and effort you've invested in it.) Similarly, if you hire an expert consultant to help you grow prize orchids, raise toucans, or race mopeds, you'll have one leg up on the ladder to convincing the IRS of your business status.

9. Don't enjoy it too much.

Another oddity relates to pleasure and enjoyment. Despite societal preoccupation with doing what you love, the IRS looks for elements of personal pleasure or recreation as one indication your "business" is really a hobby. If you enjoy what you do too much, it looks more like an avocation, and it may be treated as one.

10. Combine activities.

If a stand-alone activity produces losses, it may be more at risk of being treated as a hobby by the IRS. Yet if it can be combined with a profitable activity, the IRS might have no problem with it. The IRS says that your characterization of what constitutes a single activity will be accepted unless it's artificial and cannot reasonably be supported by the facts and circumstances. That means you can't combine your profits from your main work as a tech consultant with your losses from breeding whippets and report them as a single business activity. But if you have a profitable sideline selling handcrafted dog collars and have started up an unprofitable sideline boarding dogs, you may be able to combine the two on a single Schedule C, making it more likely that you'll show that profit three years out of five.

The bottom line.

As I noted at the start, my standard advice is to keep your business and personal life separate. But especially if you find yourself generating income from something that starts out as a hobby, it can make financial sense to consider becoming more businesslike and treating it as a business on your tax return. Just be sure you don't end up chasing tax benefits at the expense of turning an activity you once loved into a daily grind!

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