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Is It a Business or an Expensive Hobby?

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If you're convinced nobody in Washington really cares about you, here's some advice on how to get an unforgettable reaction from at least one influential government bureaucracy:

Try deducting hefty net losses from an expensive and enjoyable activity, such as photography or horse breeding, that has been a consistent money-loser for many years and has no reasonable hope of ever turning a profit. Use those losses to offset most, or even all, of your other income. While you're at it, don't bother creating or writing a formal business plan. Don't keep any records to substantiate income and expenses—and don't bother consulting with professional experts on how to be profitable.

Follow these guidelines, and you have a good chance of awakening even the sleepest agents at the Internal Revenue Service.

What others might think of as a real business might strike an IRS agent as a hobby. Why does that matter? Generally, you can

deduct legitimate hobby expenses only “up to the amount of your hobby income,” the IRS explains in a “tax tip” dated early last month. But if your expenses exceed your gross income, “you can’t deduct that loss from your other income.” (This applies not only to individuals but also partnerships, estates, trusts and S corporations.)

This issue, often lumped under the heading of “hobby-loss” cases, has long attracted close scrutiny by tax collectors concerned about possible abuses. The issue also has led to considerable confusion among taxpayers because of the complexity in deciding whether some business ventures are genuinely designed to make money.

Business or hobby? “We deal with this all the time,” says David Lifson, a certified public accountant at Crowe Horwath LLP in New York City.

Even for tax scholars, it can often prove highly taxing to figure out the difference between a legitimate business that is devoted to making a profit and a venture that isn’t. This subject may now attract even more IRS attention thanks to a report issued earlier this year by the Treasury Inspector General for Tax Administration, or TIGTA, which contends that the IRS needs to do a better job of policing this area.

“While the IRS has taken actions to address hobby loss issues, there are indications that a significant portion still needs to be addressed,” the report said. More pointedly, the report said the IRS

“can improve its methods of addressing taxpayers who offset their income with hobby losses.”

IRS officials are keenly aware of this issue. Responding to the TIGTA report, an IRS official noted several steps the agency has taken. Among them: publishing an audit-technique guide to help IRS examiners figure out whether an activity is engaged in for-profit pursuits.

As the TIGTA report indicates, this issue isn't likely to disappear any time soon. Many questions and misunderstandings have sprung up about the complex rules and fine print. What may seem to one taxpayer like a real business venture may strike the IRS very differently. Here is a primer.

First, a warning: This subject can be even more complex than it seems, and many taxpayers would be well-advised to hire a tax expert for guidance.

Q: In the IRS's view, what is the difference between a real business designed to make a profit and a “hobby”?

A: The IRS says there are nine factors to consider. “No one factor alone is decisive,” the IRS says. Check out IRS Publication 535 at [irs.gov](https://www.irs.gov) for details. Also, type “not-for-profit” in the search box on the IRS website. To see opinions by U.S. Tax Court judges, go to [ustaxcourt.gov](https://www.ustaxcourt.gov) and look under “opinions search” for hobby loss cases, or “section 183.” It's a long list. Consider reading articles on

the subject and key cases by authors such as Peter J. Reilly, a certified public accountant and blogger, and lawyer Robert W. Wood.

Q: How often does a business need to make a profit so that the IRS will presume it is a genuine business?

A: The IRS says it generally presumes an activity is carried on for profit if it made money “in at least 3 of the last 5 tax years, including the current year.” But the test is different for activities consisting mainly of breeding, training, showing or racing horses. In such cases, activities “are presumed carried on for profit if they produced a profit in at least 2 of the last 7 tax years, including the current year.”

Even if a venture fails this test, it still might have a chance of success based on the facts and circumstances of its case. “Profits help but do not determine the deductibility of business losses,” Mr. Lifson says. The IRS confirms that point. As one official puts it, “the absence of a profit in those years does not per se create a presumption that the activity is not engaged in for profit.”

Q: How should hobby expenses be deducted?

A: For starters, the tax return in question must itemize deductions. When itemizing, special rules that are too complicated to deal with here apply to certain types of expenses. Again, see Publication 535.

Q: What kinds of hobby expenses may be deductible up to the limit of the hobby's income?

A: The IRS says deductions may be allowed for certain "ordinary and necessary" hobby expenses. The IRS says an ordinary expense is "one that is common and accepted for the activity." A "necessary" expense is "one that is helpful or appropriate."

Q: How can people bolster their case that they are running a real business that is trying to make money?

A: Keep clear, comprehensive and detailed records, Mr. Reilly says. That includes not only financial details but how much time the venture requires.

Also, as explained above, making a profit in the specified number of years can win the IRS's presumption that a business is genuine. Sometimes it can be possible for the income and expenses of the business to be timed so that profits are reported in enough years to pass the "presumption" test. If there is no profit to report but the filer has a good reason to believe there will be a profit in the future, he or she should gather as much documentation as possible to bolster that case.

To help demonstrate a venture is conducted in a "businesslike" fashion, create a formal, detailed and extensive business plan. Put it in writing. Consider updating it to reflect new ways to improve profitability. Demonstrate special knowledge and expertise in the

field, or hire expert advisers.

If two or more businesses are closely connected, consider grouping them for tax advantages. It isn't easy, but some taxpayers have succeeded at this. In 2009, the U.S. Tax Court ruled in favor of Tracey L. Topping, who had deducted losses from equestrian activities that she said were part of her plan to develop a profitable interior-design business.

“The hot issue in the topic concerns ‘grouping’ two or more activities so that a profit motive from one can be applied to another,” says Barbara Weltman, a tax expert, consultant and author. Under certain circumstances, says Ms. Weltman, “multiple activities can constitute a single undertaking.”

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