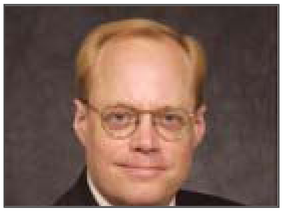
Forbes



Robert W. Wood

THE TAX LAWYER

TAXES 3/18/2015

There's Still Time To Turn Your Hobby Into A Tax Write-off

Will the IRS pay for your hobby? The short answer is no, at least if you ask the question this way. But sometimes, the IRS will foot the bill provided you make your pastime enough of a *real* business to qualify. Most people like two-fers, and killing two birds with one stone can be pretty compelling.

Say you lose $20,000 a year in the “business” of breeding, training and caring for whippets. You can report the loss on Schedule C to your Form 1040 and write it off against your salary. Assuming your combined state and federal tax rate is 40%, your whippet breeding really only costs you $12,000. That’s not bad.

If your whippets are just a hobby, then no matter how much you spend, you can’t claim a loss. But before you decide to turn your nondeductible hobby into a deductible business, be careful. This is an area of intense IRS scrutiny. The IRS has a new manual to help IRS agents ferret out taxpayers who are improperly writing off hobbies. Here are some tips that can help you get business tax treatment for a pursuit you enjoy.

1. First, try to match your income and your losses. The IRS is less likely to question whether you're engaged in a *business* if your income from the activity exceeds your expenses. It's an obvious point, and you can control some of this if you plan. It's just one of [the ABCs of hobby losses.]

2. Keep good records. The IRS will look at whether you conduct yourself in a businesslike manner. If you keep good records and hold yourself out as running a business, it will help, perhaps considerably. And keeping good records pays dividends in other ways too.

3. Show a profit three years in five. The tax law has presumptions you can take advantage of that will trump the IRS. 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. For one, it means you won't have to mud wrestle with the IRS over a more murky facts and circumstances test.

4. Plan your 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. And this factor ties in to several others. Keep good records so you can decide whether you should by that new horse trailer or fishing boat in December or wait until January. That kind of control can also help you make a profit three years out of five.

5. Delay a profits determination. Here's another special rule about hobby losses that can help you. You can elect to defer the determination of profit motive until the fourth year of your

“business,” or your sixth year in the case of an activity involving horses. To make this election you file a Form 5213, 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. Be careful, though. Most advisers don’t recommend this election, since it might flag the profit-motive issue. Plus, it has the effect of extending the IRS statute of limitations beyond the normal three years. The IRS can examine all the years in question after the deferral period has passed. Remember, if you make certain tax mistakes, they can allow the IRS to audit you forever!

For alerts to future tax articles, follow me on Forbes. You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.