PERSPECTIVE

Los Angeles | Daily Journal

FRIDAY, AUGUST 5, 2016

When Can You Tell The IRS A Hobby Is Really A 'Business'?

By Robert W. Wood

If you *make* money, it is always taxable no matter what, but the rules are different if you *lose* money. So, before you start a new venture, you might start by asking if you can write off your losses. If it is a real business, the answer is yes. If it is just a hobby, the answer is no — well, at least if you ask the question this way.

But sometimes, the Internal Revenue Service will actually pay for part of it, provided you make your pastime enough of a real business to qualify. 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 IRS Form 1040, and write off the loss against your salary. Assuming that your combined state and federal tax rate is 45 percent, your whippet breeding "business" really only costs you $11,000.

That's not bad. If your whippets are just a hobby, then the $20,000 you spend costs you the full $20,000. With a hobby, no matter how much you spend, you can't claim a loss. But before you make plans, consider the nature of your activity. Most hobby tax cases involve activities that are fun, like racing cars, breeding horses, pets, part-time farming, and so on. But Amway?

Yes, Amway, and there are many tax cases on point, including the recent case of *Hess v. Commissioner*, T.C. Summ. Op. 2016-27. There, the Tax Court ruled that someone who loses money selling Amway products cannot deduct the losses. Selling Amway is a hobby, at least in the discerning eyes of the IRS and courts. Time and again, the IRS has invoked the hobby loss rules to disallow losses from Amway "businesses."

In fact, the audit history of taxpayers who sell Amway is so poor that many seem to have learned to omit the name "Amway" from their tax returns. Amway supplies household and personal use products. The products are resold by individuals called "distributors." Distributors also recruit others into what is known as a "pyramid" incentive system.

New recruits become "downline" distributors of a sponsoring ("upline") distributor. Amway pays a bonus to upline distributors based on the volume of sales generated by their downline distributors, and the ones downline from them, and so on. A distributor's primary goal is to climb far upline, because that's where the most profit potential lies. In that sense, the big money is not in your own selling.

The big money lies in overseeing a vast "organization." So, many distributors may end up spending much of their time courting new recruits rather than selling. To maximize Amway income, a distributor should sell Amway products and also enlist others as distributors. But as a hobby?

Amway does not fit neatly into a fun or recreational category. Plainly, it is not your run-of-the-mill hobby, such as stamp collecting or competing in horse shows. Perhaps aware of the intuitive problems with hammering the Amway peg into the "hobby" hole, the Tax Court has gone to great lengths to find fun in Amway.

For example, the Tax Court said that "[a] major reason why many individuals remain committed to Amway is the congenial sense of family and the gratifying motivational feeling they derive from participating in the activity." See *Nissley v. Commissioner*, T.C. Memo. 2000-178. The court said there was pleasure from the "opportunities to generate business deductions for essentially personal expenditures."

In another case, the Tax Court found that "there are significant elements of personal pleasure attached to the activities of an Amway distributorship." *Brennan v. Commissioner*, T.C. Memo. 1997-60. In the recent *Hess* case, the Tax Court denied the losses in part because Mr. Hess did not have any sort of a business plan. Business plans are business-like, and his was not.

You don't need a business plan to *make* money, of course. But if you *lose* money year after year and are trying to write off your losses against other income, you better have one. Mr. Hess reported net losses from 2005 to 2011 ranging from $10,000 to $25,000. In only one year did his gross revenue exceed $1,500.

Despite generating losses from Amway activity year after year, he kept operating the activity in the same manner. He didn't hire consultants or turnaround people (that would be business-like) regardless of the prior year's results. In fact, he did not seek advice from anyone other than their sponsoring distributors.

Many other Amway cases involve a similar pattern. For example, in *Nissley v. Commissioner*, T.C. Memo. 2000-178, a husband and wife were both licensed CPAs. They were recruited by an upline Amway distributor, and they thereafter operated an Amway distributorship for eight years. They did not make a profit for eight years in a row.

On their tax returns, they identified their business proprietorship as "product distribution" but they conveniently omitted calling it Amway. Still, they were audited by the IRS, and were asked to prove that they were trying to make a profit. It looked like they were just writing off expenses. In fact, a major portion of their deductions were for purchasing supplies, traveling to seminars, running an office, and paying for their two cars.

Notably, they had an eight-year history of successive losses! The court explained that the profit goal of an enterprise must be not only for some future profit, but enough to recoup prior losses. In some horse breeding cases, the "business" loses money for five or even ten years before winning the Kentucky Derby.

But in most cases, too many losses in a row just spell hobby. And here — perhaps especially with Amway — eight successive years of losses convinced the court that recouping those losses was no longer likely. The court also focused on whether the taxpayers operated their distributorship in a businesslike manner, one indicia of which is keeping good records. Treas. Reg. Section 1.183-2(b)(1).

The two CPAs were good at this part, keeping meticulous records. At first blush, one might think that this factor weighed in favor of a profit motive. Some hobby loss cases do turn on records. But here, good records were not enough to tip the balance.

The Tax Court in *Nissley* found that these accountants kept detailed records of expenditures, but those admittedly good records failed to help them show that they actually had a profit motive. The court said this was just all about claiming tax losses to offset wage income. And that brings us to Herbalife, a company that has sometimes been compared to Amway.

I have not yet seen Herbalife tax cases, but it could only be a question of time. So, with Amway, Herbalife, or with more traditional fun hobbies, it is worth considering whether you want to try to turn your nondeductible hobby into a deductible business. This is an area of intense IRS scrutiny.

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