Sy Accountancy Corporation
Member, American Institute of CPAs
704 Mira Monte Place, Pasadena, California 91101
Tel (626) 744-0200 • Fax (626) 744-0300 • vsy@victorsycpa.com • www.victorsycpa.com

HOBBY LOSS RULES - BUSINESS OR HOBBY?

By Victor Sy, CPA

It's cool to run a business that you truly enjoy, such as photography, dance studio, martial arts, dog-breeding, farming, and other leisurely activities. If you convert that pastime into a regular business, try to make some money; otherwise, you may attract an IRS audit, especially if your new enterprise consistently generates losses. IRS may claim that you have a hobby - an activity not engaged in for profit. Loss from hobby is not deductible.

Under hobby loss rules, you'll be able to claim usual deductions that are available whether or not the enterprise is engaged in business for profit (such as state and local property taxes). However, your deductions for business-type expenses (such as rent or advertising) will be limited to the excess of your gross income from the hobby over those expenses that are deductible whether or not the enterprise is engaged in for profit. Deductible hobby expenses are claimed on Schedule A of Form 1040 as miscellaneous itemized deductions subject to a 2%-of-AGI floor (beware of audit risk if you take big ticket items under miscellaneous expenses of Schedule A). By contrast, if the company is not affected by hobby loss rules, all otherwise allowable expenses would be deductible on Schedule C, even if they exceeded income from the company.

There are two ways to avoid the hobby loss rules.

1. The first way is to show a profit in at least three out of five consecutive years (two out of seven years for breeding, training, showing, or racing horses).
2. The second way is to have a profit-making objective. Run the venture to show that you intend to turn it into a profit-making venture, rather than operate it as a mere hobby. IRS regs state that hobby loss rules won't apply if the facts and circumstances show that you run a business for profit.

How can you prove that you have a profit-making objective?

Here 10 tips that IRS and the courts look to:

1. Whether you run your new venture in a businesslike manner.
2. Your expertise in the area.
3. The expertise of your advisers.
4. The time and effort you expend in the enterprise.
5. Whether there's an expectation that the assets used in the activity will rise in value.
6. Your success in carrying on other similar or dissimilar activities.
7. Your history of income or loss in the activity.
8. The amount of occasional profits (if any) that are earned.
9. Your financial status.
10. Whether the activity involves elements of personal pleasure or recreation.

The classic "hobby loss" situation involves a successful businessperson or professional who starts something like a dog-breeding business or a farm. If the IRS determines that the dog-breeding project or farm is more for enjoyment rather than making money, it could be classified as a hobby. Losses will not be deductible.