

Avoiding the Hobby Loss Trap

Classifying an activity as either a business or a hobby is critical for tax purposes since you cannot deduct losses from hobbies on your tax return. Making this determination, however, is not always clear-cut. The IRS “backs-into” the definition of activities not engaged in for profit (i.e., hobbies) by including all activities other than those that qualify as business or investment activities. Thus, the facts and circumstances of each activity must be reviewed.

Many hobby loss issues center on the weekend farmer or rancher. However, the rules are applicable to any type of activity, and have frequently been applied to auto racing; horse (or dog) racing, breeding, or showing; cattle breeding; and acting, films, and filmmaking. In any case, your activity must be conducted with the actual and honest intent of making a profit to escape the hobby loss taint.

ESTABLISHING A PROFIT MOTIVE

The IRS considers many factors when determining if you are out to make a profit in an activity. These include the existence of a sound business approach, your expertise in the particular activity, how much time and effort you devote, and if there is a reasonable expectation that your business assets will appreciate in value. The IRS also looks at your activity’s past financial performance, including the occurrence of profits and losses and their relative size, your degree of success with any previous businesses, whether you have substantial income from other sources, and the level of personal pleasure or recreation you received.

COMBINING ACTIVITIES TO AVOID HOBBY TREATMENT

Combining a questionable activity with a legitimate business may help you avoid hobby treatment. For example, the Tax Court allowed a Kentucky farmer who opened a public display garden and conservatory to aggregate the farming and garden activities for testing under the hobby loss rules because the activities had a close organizational and economic relationship. Conversely, the Tax Court rejected a dentist’s claim that his dental practice and apple orchard should be treated as a single activity because the apples provided health benefits to his patients.

USING THE SAFE HARBOR RULE TO ELIMINATE UNCERTAINTY

A safe harbor test exists that, if met, causes a presumption that your

activity is a for-profit endeavor. If the safe harbor is not met, you must establish a profit motive using the subjective factors previously discussed. To meet the safe harbor, your activity must generate a profit in at least three of five years (two of seven years for activities involving horse racing, breeding, or showing) ending with the tax year in question. If the safe harbor is met, the burden of proof for lack of a profit motive is shifted from you to the IRS. The IRS can still rebut the profit motive presumption by proving that the activity is not engaged in for profit. In most cases however, the IRS will not attempt to rebut the presumption unless there are extenuating circumstances.