

IRS HOBBY LOSS RULES:

Turn your personal passion into tax savings

Tax Strategies, Business management Daily, Vol. 7, No. 3 March, 2012

Has your hobby grown into a full-time or sideline business? You might need to convince the IRS.

Strategy: Run the activity just like any other business: Keep accurate and detailed records, maintain any requisite licensing and meet other technical responsibilities. In all respects, keep your business separate from your personal pursuits.

If you qualify, you can deduct your legitimate expenses as a self-employed individual. Even better, you might use a business loss to offset high-taxed income like wages from a full-time job or investment earnings.

On the other hand, if the activity is treated as a hobby, your deductions are limited to the income received from the hobby. You can't claim an overall tax loss on your return.

Also, if an activity is considered a hobby, the expenses must be deducted as miscellaneous expenses on Schedule A, instead of Schedule C for self-employed individuals.

The problem: Miscellaneous expenses are deductible only to the extent the annual total exceeds 2% of your adjusted gross income (AGI). And they are completely nondeductible under the AMT rules.

8 questions are enough

In a recently issued fact sheet on hobby losses (FS- 2008-23), the IRS posed eight questions to determine the status of a particular activity.

1. Does the time and effort put into the activity indicate an intention to make a profit?

2. Does the taxpayer depend on income from the activity?
3. If there are losses, are they due to circumstances beyond the taxpayer's control or did they occur in the startup phase of the business?
4. Has the taxpayer changed methods of operation to improve profitability?
5. Does the taxpayer or his or her advisors have the knowledge needed to carry on the activity as a successful business?
6. Has the taxpayer made a profit in similar activities in the past?
7. Does the activity make a profit in some years?
8. Can the taxpayer expect to make a profit from the appreciation of assets used in the activity?

The more "yes" answers, the better your chances of qualifying for business deductions. *Tax law presumption:* An activity is presumed *not* to be a hobby if you show a profit in any three out of the past five consecutive years. For activities involving the breeding, training, showing or racing of horses, the activity is presumed not to be a hobby if it shows a profit in only two out of the past seven consecutive years.



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