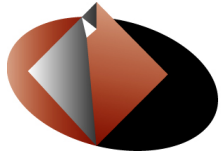


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EXCLUSIVE TAX ISSUE

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Business or Pleasure Department: Hobby Losses Hit IRS Radar

by David Herzog, Associate

Economic downturns inspire people to make money in all sorts of ways. In some instances, hobbies become businesses. Some transitions are successful, some are not. Those that aren't catch the attention of the IRS when taxpayers treat their hobbies as businesses on their tax returns.

Why? Because if your hobby is just a hobby, then any deductions it generates, even if otherwise allowable, are limited to its income, which means: for a hobby, you can not create a loss to offset your other income. On the other hand, if your hobby is more than just a hobby, i.e., a for-profit business, then your deductions, as with any business, if they exceed your enterprise's income, can create a loss you can use to carry back, carry forward ([see my newsletter on NOLs](#)), or use in the current year.

So, what does it mean to be engaged in an activity *for profit*?

You start by running your venture to show that you intend to turn it into a profit-maker, rather than operate it as a mere hobby. In general, you can do so by running the new venture in a businesslike manner.

More specifically, the IRS and the courts will look to the following factors to determine profit intention: how you run the activity; your expertise in the area (and your advisers' expertise); the time and effort you expend in the enterprise; whether there's an expectation that the assets used in the activity will rise in value; your success in carrying on other similar or dissimilar activities; your history of income or loss in the activity; the amount of occasional profits (if any) that are earned; your financial status; and whether the activity involves elements of personal pleasure or recreation.

In a recent case, a taxpayer, Robert Rowden, purchased a 50% interest in a 1975 Cessna, which was not airworthy at the time. He worked on the Cessna for 20 to 30 hours per week, and worked on airplanes owned by other people as well. Despite the number of hours he put in, the court said that Mr. Rowden's enterprise in "Aircraft Maintenance" was not conducted in a businesslike manner with regularly maintained records of invoices and other items on which profits and operational performance could be measured, his enterprise generated losses in the subject years, and contained significant elements of recreation and personal pleasure. "[His] records consisted of a collection of receipts," stated the Court. Essentially, the Court questioned whether Mr. Rowden entered into and/or continued the activity with the objective of make a profit. Clearly the Court decided he did not.

The IRS doesn't always win: In another case, the IRS tried to argue that Tracey Topping's horse-racing activity was a hobby, and not related to her interior design activity. Tracey presented sufficient evidence to show that her equestrian activities (including her Jockey Club memberships) were intended to, and did, in fact, generate clients. (She'd dropped her golf club membership when that did not produce clients.) Tracey's entire business model was centered around the objective of showing that she could circulate in, and compete in, upper class activities, and that she used her knowledge of equestrian life to design homes for people with that lifestyle in mind. She kept records, consulted with professionals, and completely integrated these two activities into her one business enterprise. Not only did she eventually turn a profit, but she prevailed in Tax Court.

In these days of creative money-making by taxpayers on the one hand, and even more creative ways by the IRS of generating revenue on the other hand, hobby losses are high on the IRS' radar. Keep that in mind as you continue to maintain your records (you are maintaining your records, right?) during this 2009 tax year.

This article is intended as a general guideline. The rules are complex, and changing continually. Please consult your tax advisor.

If you have any questions or suggestions for article topics, please feel free to email David at dherzog@pinnaclelawgroup.com.

Please be advised that, based on current IRS rules and standards, the advice above was not intended or written to be used, and it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. If this message is provided in any manner to another taxpayer they cannot use the advice and should seek advice based on their own particular circumstances from an independent tax advisor.

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