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# TURNING HOBBY LOSSES INTO BUSINESS LOSSES

It happens on more than one occasion that a person turns a hobby into a business and makes money. After all, if it is something you like doing, you tend to do it better, and spend time learning, improving, and mastering the activity. These are all some of the basics tenets of success in business.

Your government loves this. A hobby that starts producing profits means taxable income which translates into more taxes. Why wouldn't this be well received?

However, the reverse is not always true. Losses that emanate from a business which could be construed as a hobby-type activity are frequently subject to government challenge in an audit. This is because these losses can be used to offset other taxable income you may have, resulting in your paying less taxes. So, there is a form of polarization here. The taxpayer may be happy with the losses which could save up to 40% in taxes for some. Obviously, the government may not be as happy with these results.

The key here is to work within the system to be able to use hobby-type losses to save taxes. The way to do it is to make sure the hobby-type activity qualifies as a business, not a hobby, under the current 2000 IRS guidelines. In terms of IRS tax code, you want to qualify under Code Section 162, or Code Section 212 which refer to a trade or business and/or the production of income.

You don't want to get categorized under Code Section 183 which is an "activity not engaged in for profit," since this makes the net losses non-deductible.

To help your cause in being able to deduct these losses, there are a number of issues, or tests that are considered under current audit guidelines. The successful qualification within these parameters goes a long way toward the allowance of these losses against other forms of income. This isn't to say ALL of the guidelines must be met. It is a matter of the relativity of these guidelines compared to the specific activity in question. Let's look at the guidelines that are used to establish the activity as a business rather than a hobby.

The main parameters that are currently used as guides to the deductibility of hobby-type business losses are as follows:

1. **Amount of profits earned, and occasion of such profits:** Obviously, if the activity produces consistent profits, there is no problem. There are no losses of concern. If the profits are only occasional and the losses are more frequent, the tests here are twofold. First, a relatively large profit, even if only occasional, would tend to support the idea that it is a business more than a hobby. Second, if the losses are relatively larger than the occasional small profits, and consistently so, then it tends to be viewed more as a hobby.

2. **Reason for, or history of losses:** Losses in the early phases of a business are common, and aren't necessarily held against you. Similarly, losses due to circumstances beyond your control(such as from disease, casualty, weather, market conditions, etc.) are taken into positive reference. So continued losses without profits in this case would not necessarily be a detriment.

3. **The degree of personal pleasure in the activity:** The more this factors in, the more suspect the activity with the IRS. Model train collecting, horse breeding, art painting, etc., where the business owner or family members participate heavily in the recreational aspects, causes more problems than perhaps other activities.

4. **Degree of benefit of losses:** The economic status of the taxpayer enters in here. The more you have income from other sources besides the hobby-type activity, and the more you benefit from the losses tax-wise, the more it may be challenged. If you are deriving the bulk of your income from the activity, or if the losses are not saving you much in taxes, it becomes more of a moot issue to challenge.

5. **Experience, or expertise of the taxpayer:** Those with significant expertise in the related field, or those who can prove they are making continued efforts to become knowledgeable stand a better chance. If you use advisers in the activity, if you go to school, trade shows, or buy books, to name a few possibilities, you reinforce that you are trying to make positive efforts to understand the market, and eventually overcome the current losses.

6. **Time spent on the activity:** If you spend a significant amount of time in the running of this activity compared to other income-producing activities, it helps show you view this hobby-type activity as more of a business with income potential. If you spend 3 hours a week on stamp collecting vs 37 hours a week earning money elsewhere, it could be difficult writing-off losses year-by-year from this activity.

7. **The "business-like" nature of the activity:** This is perhaps the most frequently-used major test. One difference between a business and a hobby is in how the activity is run. If good financial records are maintained, a proper bookkeeping/ recordkeeping system is used, and possibly a separate checking account is kept, then a better case can be made that it is a business, not a hobby. Similarly, if you can prove you made reasonable attempts to market or advertise this activity to generate revenues, it supports your case.

## Is There A Loophole For All Of This?

A possible general "loophole" exists where you can show that a reasonable profit occurred in two out five consecutive years of operations. If this is the case the IRS tends to assume the activity was done for profit, hence the loophole since no challenge may be in order. Note however, that the degree of profit is important compared to the degree of loss. Very small profits for two years vs large losses for the other 3 years may not be enough to keep the IRS from trying to challenge.

Since the challenge is done "after-the-fact," the IRS has the benefit of hindsight. It's too late for you to go back in time to shore up your position. If you lose this challenge, these losses, both future and past (within the appropriate statute of limitations), can be disallowed resulting in a possible hefty tax bill for you to pay– plus interest and possible penalties. So contemporaneous recordkeeping and marketing activities are the watchwords here.

However, if you do your homework and the loss-producing activity is handled correctly, this can be a wonderful tax-saving opportunity. You or members of your family may have the chance to enjoy a fun activity, write-off its expenses, and reduce your taxes all at the same time. So it is worth the consideration.