Pay attention to the tax rules if you turn a hobby into a business

Many people dream of turning a hobby into a regular business. Perhaps you enjoy boating and would like to open a charter fishing business. Or maybe you'd like to turn your sewing or photography skills into an income-producing business.

You probably won't have any tax headaches if your new business is profitable over a certain period of time. But what if the new enterprise consistently generates losses (your deductions exceed income) and you claim them on your tax return? You can generally deduct losses for expenses incurred in a bona fide business. However, the IRS may step in and say the venture is a hobby — an activity not engaged in for profit — rather than a business. Then you'll be unable to deduct losses.

By contrast, if the new enterprise isn't affected by the hobby loss rules, all otherwise allowable expenses are deductible, generally on Schedule C, even if they exceed income from the enterprise.

Important: Before 2018, deductible hobby expenses could be claimed as miscellaneous itemized deductions subject to a 2%-of-AGI "floor." However, because miscellaneous deductions aren't allowed from 2018 through 2025, deductible hobby expenses are effectively wiped out from 2018 through 2025.

How to NOT be deemed a hobby

There are two ways to avoid the hobby loss rules:

1. 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. Run the venture in such a way as to show that you intend to turn it into a profit maker rather than a mere hobby. The IRS regs themselves say that the hobby loss rules won't apply if the facts and circumstances show that you have a profit-making objective.

How can you prove you have a profit-making objective? You should operate the venture in a businesslike manner. The IRS and the courts will look at the following factors:

- How you run the activity,
- Your expertise in the area (and your advisors' 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 activities,
- Your history of income or loss in the activity,
- The amount of any occasional profits earned,
- Your financial status, and
- Whether the activity involves elements of personal pleasure or recreation.

Case illustrates the issues

In one court case, partners operated a farm that bought, sold, bred and raced Standardbred horses. It didn't qualify as an activity engaged in for profit, according to a U.S. Appeals Court. The court noted that the partnership had a substantial loss history and paid for personal expenses. Also, the taxpayers kept inaccurate records, had no business plan, earned significant income from other sources and derived personal pleasure from the activity. (*Skolnick,* CA 3, 3/8/23)

Contact us for more details on whether a venture of yours may be affected by the hobby loss rules, and what you should do to avoid tax problems.