

Avoiding the Hobby Tax Trap

Let's Talk Tax

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Many questions HBS Tax receives from business owners involve business structures. Some want to know how sole proprietorships and LLCs differ. Others want to know the tax advantages of partnerships, corporations and S Corporations.

In upcoming weeks I will share the basic tax-implications of various business structures. Before starting, however, a few words of warning for those contemplating the “form” their business will take: Business structures are highly complex. The choice of structure is often one of the first decisions owners make with regard to their business. It is also one of the longest-lasting and financially consequential. No article can provide enough information to base such an important decision. Before committing to a particular structure, study the pros and cons of each option in light of your long-term business objectives. Then consult with tax and legal professionals before making a final decision.

Today's article will discuss the “non-business” business structure – the hobby and the “tax trap” it can spring on unsuspecting owners.

New businesses commonly sustain losses in the first few years of operation - losses which may be deducted on the owner's tax return. Unfortunately, businesses that are not operated in a “business-like” manner run the risk of springing the hobby tax trap – having the activity declared

a hobby by the IRS. If this happens the IRS may disallow these losses and make all hobby revenue taxable, most related expenses nondeductible, and the owner liable for back-taxes, penalties and interest.

Hobbies receive less favorable tax treatment than businesses. All hobby income must be reported on the front of the hobbyist's income tax return. This is generally line 21 (Other Income) unless the hobby involves buying and selling collectibles, which is subject to capital gain rules and reported on Schedule D. Only collectors can offset sales income by deducting their basis (their investment) in sold collectibles – up to the point of breaking even. Expenses associated with other hobbies can only be deducted in a special order as itemized deductions on schedule A. With the exception of certain deductions such as mortgage interest and property taxes, hobby deductions - whether trading coins, selling makeup, or trading extra produce from the garden - cannot generate a loss.

The IRS defines a hobby as a revenue-generating activity that lacks a profit motive. A “business” activity that lacks a profit motive is a hobby, not a business. The IRS will generally assume an activity is a business if it generates a profit three of five consecutive years (this period may be longer for other activities such as horse racing, showing, and breeding). If the activity generates losses for three of five years the IRS may review the “facts and circumstances” to determine whether the activity is a for-profit business or a hobby. If the activity is reclassified as a hobby, the IRS may add back the losses claimed on tax returns, resulting in back-taxes, penalties, and interest.

If your business has sustained losses for the past few years you can avoid the hobby tax trap by making sure the facts and circumstances are on your side. Be prepared to show the following: 1) Proper licensing, 2) Separate business bank accounts and credit cards, 3) Payment of all business taxes, 4) Good accounting records, 5) Applicable insurance and separate business phone line, 6) A log showing that substantial time is devoted to the activity, and 7) Documented actions taken to help make the activity profitable.

This will not automatically prove a profit motive. It will, however, greatly reduce the odds of the IRS classifying the activity as a hobby and help substantiate that you are entitled to any business losses you have claimed on your income tax return.

In today's article I have discussed the tax implications of hobbies. In the near future I will visit sole proprietorships and partnerships, then move on to LLCs, Corporations and S Corporations. If you have questions regarding the taxation of your business or need help with any other tax issue, please feel free to contact our office to consult with a tax professional.

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