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Is That a Deductible Business Loss or Non-Deductible Hobby Loss?

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Many of us might have unincorporated for-profit businesses where we are able to eke out some money. In some years we might lose money when our expenses exceed our profits. Then, we might assume we could deduct such losses. Unfortunately, it is not as simple. In fact, if the IRS designates our sideline business as a hobby not a business, then we cannot deduct losses exceeding our revenue in that year. Therefore, it is imperative to understand whether our sideline business is really a business in the eyes of the IRS or a hobby.

SOME BACKGROUND

A. Business Loss: Generally Deductible

If you have a business and your expenses for a given year exceed your earnings, then you would claim such losses on your tax bill. such business losses would offset other income you have from other sources. This means considerably less taxes.

B. Hobby Loss: Generally Not Deductible

If you have a for-profit unincorporated business activity and the IRS treats it as a hobby not as a business, then your losses in that business are allowable to the extent of your revenue from that activity. This means that you can never have any allowable net loss since what you made in that year was less than what your expenses were.

In addition, this means you have to itemize your expenses as miscellaneous itemized deductions. Such deductions are also hard to deduct since you are allowed to deduct your miscellaneous itemized deductions to the extent they exceed your Adjusted Gross Income (AGI) by 2%.

The result is that if you have a hobby you may not be able to deduct any of the losses, but end up reporting any income from the hobby. This is not a happy situation.

WHAT IS NOT A HOBBY?

The IRS assumes you have a for-profit business, if you have:

- **Positive Taxable Income in Every Three years Out of the Past Five Years:** You have had revenue in excess of deductions, in the past three out of at least every five years. So, losses from any other years can be deducted because they are deductible business losses and not hobby losses.

- **Positive Taxable Income in Two Out of Every Seven Years for Horse Racing, Breeding or Training:** If you are involved in any of these activities, then you should plan ahead of time to have revenue in excess of deductions for at least two years our of every seven years. Then, you would be able to claim your losses from unprofitable years.

WHAT TO DO IF YOUR FOR-PROFIT UNINCORPORATED BUSINESS DOES NOT FIT THE AUTOMATIC CATEGORIES?

The question arises as what to do if your for-profit unincorporated business does not fit any of the automatic categories delineated earlier. Then, you MUST show your honest intent. The way to show your honest intent to make a profit is for you to prove it through the following factors:

- **Treat It Like a Business:** You need to keep records and show you search for strategies to be profitable.
- **Have Expertise in the Business:** Do you know what you are doing or are you associating with people who know the business?
- **Allocate Enough Time to the Business:** The amount of time you spend to make money could be important.
- **Expect Asset Appreciation:** The IRS will nearly never claim a real estate asset is a hobby since people purchase real estate in hopes the value appreciates.
- **Demonstrate Financial Need to Have the Loss Deducted:** Non-wealthy people cannot afford to incur losses. On the other hand, the affluent might incur huge losses for pleasure.
- **Demonstrate Business Acumen in Other Businesses**: If you have been successful in other businesses, you are more likely to ague you are a risk taker and might incur some unanticipated losses.
- **Demonstrate the Type of Business Is Not for Hobby:** If the activity involves a lot of pleasure, then that would be more difficult to prove than a relatively unpleasant activity. Nonetheless, the IRS by looking at other factors has decided sailboat racing or drag racing is business.

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