

III. THE BASICS – TRADE (OR BUSINESS) OR HOBBY

- A. IRC Sec. 162 allows as a deduction “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. A bona fide business must truly exist prior to claiming expenses under IRC Sec. 162. An expense may qualify as ordinary and necessary if it is appropriate and helpful in carrying on a trade or business, is commonly and frequently incurred in the type of business conducted by the taxpayer, and is not a capital expenditure.” (*Welch v. Helvering*, 290 U.S. 111 (1933))

WARNING: A trade or business expense deduction under IRC Sec. 162, however, is not permitted with respect to a taxpayer’s residence unless specifically permitted in certain limited circumstances by IRC Sec. 280A. IRS examiners are specifically tasked to consult the rules of IRC Sec. 280A (which generally supersedes the IRC Sec. 183 rules) if the taxpayer’s deductions are suspect and involve a personal residence. See Rev. Rul. 2004-32.

- B. For the expenses to be deductible under IRC Sec. 162, the taxpayer must engage in or carry on an activity to which the expenses relate with an actual and honest objective of making a profit. (See *Keanini v. Comr.*, 94 T.C. 41 (1990) (citing *Golanty v. Comr.*, 72 T.C. 411, 425 (1979), aff’d without published opinion, 647 F.2d 170 (9th Cir. 1981)); *Dreicer v. Comr.*, 78 T.C. 642 (1982), aff’d without opinion, 702 F.2d 1205 (D.C. Cir. 1983)).
- C. Taxpayers bear the burden of proving that they engaged in the activity with an actual and honest objective of realizing a profit.
1. In *Richard Kay, Jr. v. Comm.*, TC Memo 2011-159, the taxpayer attempted to be treated as a securities trader and filed Schedule C for his securities transactions. The taxpayer traded securities on 73 days in 2000,

18 days in 2001 and 21 days in 2002 with 313, 172 and 84 transactions in each year, respectively. Even though the taxpayer made over \$20 million in purchases and sales in 2000, the Tax Court found the activity to be infrequent and denied Schedule C treatment.

2. The endeavor must be a bona fide business. In *Liaosheng Zhang v. Comm.*, TC Memo 2011-18, the taxpayer attempted to disguise improper personal and family deductions as business deductions for a website business.
 3. In *Batok v. Comm.*, TC Memo 1992-727, the Court found that a one-time job did not rise to a business subject to self-employment tax.
- D. The taxpayer must devote time to the business in the honest belief that the business will sometime in the future become profitable. It is necessary for the taxpayer to show what their projected profit is expected to be.
- E. Whether or not an activity is presumed to be operated for profit requires an analysis of the facts and circumstances of each case. Deciding whether a taxpayer operates an activity with an actual and honest profit motive typically involves applying the nine non-exclusive factors contained in Reg. 1.183-2(b). Those factors are:
1. The manner in which the taxpayer carried on the activity,
 2. The expertise of the taxpayer and his advisors,
 3. The time and effort expended by the taxpayer in carrying on the activity,
 4. The expectation that the assets used in the activity may appreciate in value,
 5. The success of the taxpayer in carrying on other similar or dissimilar activities,
 6. The taxpayer's history of income or loss with respect to the activity,
 7. The amount of occasional profits (if any) that are earned,
 8. The financial status of the taxpayer and
 9. Elements of personal pleasure or recreation.
- F. No single factor controls, other factors may be considered, and the mere fact that the number of factors indicating the lack of a profit objective exceeds the number indicating the presence of a profit objective (or vice versa) is not conclusive. For example, if five factors say the activity is not for profit, but four are on the profit side, the activity still could be determined to be engaged in for profit. More weight is given by the courts to objective facts than to the taxpayer's statement of his or her intent (*Dreicer v. Comr.*, 78 T.C. 642 (1982)).

NOTE: Per the IRS' ATG (audit technique guide) for activities not engaged in for profit, "A profit objective in an earlier year does not automatically provide a taxpayer a blank check with regard to losses incurred in later years. For example, in a later year an activity may be treated as an activity not engaged in for profit even though in an earlier year the activity may have been conducted by the taxpayer with a profit objective. See *Daugherty v. Comm.*, T.C. Memo 1983-188; *Dennis v. Comm.*, T.C. Memo 1984-4.

- G. IRC Sec. 183(d) provides a presumption that an activity is engaged in for profit if the activity is profitable for three years of a consecutive five-year period or two years of a consecutive seven-year period for activities that consist of breeding, showing, training, or racing horses.
1. This presumption rule applies only after an activity incurs a third profitable (or second) profitable year within a five-year (or seven-year) presumption period that begins with the first profitable year.

EXAMPLE: Rollin' Mike Racer has the following profits (losses) from a car racing activity.

	2005	\$(30,000)	
	2006	\$ 5,000	
	2007	\$(60,000)	
	2008	\$ 2,000	
	2009	\$ 5,000	
	2010	\$(70,000)	
	2011	\$ 3,000	
	2012	\$(63,000)	

The first five-year presumption period begins with the first profitable year of 2006, but the benefit of the presumption does not begin until the third profit year of 2009. The presumption is not available for 2006 through 2008 because it does not apply until the third profit year. The presumption is available during the first presumption period only in 2009 and 2010. The second five-year presumption period begins with the 2008 profit year and runs through 2012. The presumption applies to the third profit year of 2011 and will be of benefit for 2011 and 2012.

2. If the taxpayer meets the presumption rule, the Service can still argue that the activity is not engaged in for profit; however, the burden of proving that the activity is not engaged in for profit shifts to the Service. In addition, examiners cannot use IRC Sec. 183(d) as the sole basis for disallowing losses under IRC Sec. 183 even if it is shown that the taxpayer has not met the presumption rule.

1040 INDIVIDUAL TAX

- H. Under IRC Sec. 183(e), a taxpayer may elect to postpone a determination of whether the presumption applies until the close of the fourth taxable year (or the sixth year for qualifying horse activities) following the first taxable year in which the taxpayer engages in the activity. An electing taxpayer may file returns in the interim on the assumption that the activity is conducted for profit.
1. If an activity that is generating losses has not yet been carried on for the full profit presumption period, the taxpayer may elect to postpone a determination of whether or not an activity is engaged in for profit.
 2. Form 5213, Election to Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit, is used when taxpayers wish to postpone an IRS determination as to whether the presumption applies that they are engaged in an activity for profit.
 3. The election to postpone determination generally can be filed anytime within three years after the due date of the return (determined without regard to extensions) for the first year of the activity but not later than 60 days after the taxpayer receives written notice from the IRS proposing to disallow deductions attributable to the activity.

TIP: Form 5213 is rarely used by taxpayers until an examiner proposes to disallow the activity as not engaged in for profit.

WARNING: The IRS' audit technique guide for hobby losses lists several "possible IRC Sec. 183 activities" including fishing, farming, craft sales, dog breeding, gambling, direct sales (e.g. Mary Kay or Pampered Chef), entertainers, horse racing, motorcross racing, bowling, yacht charter, photography, airplane charter, horse breeding, auto racing, stamp collecting, artists, writing and rentals.

- I. Reg. 1.183-1(e) provides that for purposes of IRC Sec. 183, gross income derived from an activity not engaged in for profit includes the total of all gains derived from the sale, exchange, or other disposition of property, and all other gross receipts derived from such activity. Gross income may be determined from any activity by subtracting the cost of goods sold from the gross receipts as long as the taxpayer consistently does so and follows generally accepted methods of accounting in determining such income.
- J. If an activity is not engaged in for profit, deductions are allowable under IRC Sec. 183(b) in the following order on the Schedule A and only to the following extent:
 1. First, deduct expenses that are allowable without regard to the taxpayer's profit motive from the gross income produced by the activity (e.g. taxes, mortgage interest, casualty and theft losses and contributions).
 2. Second, deduct expenses that would be allowable if the activity were to be engaged in for profit. For example, rent, labor, wages, travel, and transportation. These expenses are limited to the amount of gross income less the expenses in #1 above.

SOLE PROPRIETOR – SCHEDULE C

3. Third, deductions leading to basis adjustments (e.g. depreciation and amortization). These expenses are limited to the amount of gross income from the activity less the expenses in #1 and #2 above. Allowed depreciation must be allocated to each depreciable asset.
4. The allowed expenses are reported as itemized deductions possibly subject to the overall limitation on itemized deductions and subject to the 2% AGI floor for miscellaneous itemized deductions. Also, for alternative minimum tax purposes, no deduction is allowed for miscellaneous items, as defined in IRC Sec. 67(b).

X. TRADE OR BUSINESS CHECKLIST

TRADE OR BUSINESS CHECKLIST	Yes	No	N/A
1. Does the taxpayer carry on the activity in a business-like manner?			
2. Does the taxpayer and/or his advisors have the required expertise in the activity?			
3. Does the taxpayer devote sufficient time and effort to the activity?			
4. Are asset values appreciating (or expected to appreciate)?			
5. Has the taxpayer been successful in other business ventures?			
6. Is there a reasonable explanation for a string of years with losses?			
7. If there are occasional small profits but lots of large losses, is there any anticipation of a change in the pattern?			
8. Is the activity the primary source of income for the taxpayer?			
9. Does the activity seem to be more business than pleasure or recreation?			
10. Are there any other factors indicative of a business as opposed to a hobby?			

Notes: A "yes" answer suggests a favorable response. A "no" answer suggests an unfavorable response. Remember this is a facts and circumstances test and no one item is controlling.

Please check the applicable box.

- I have read the accompanying summary of business versus hobby rules. I would like to continue to treat my activity as a for profit business for income tax reporting purposes.

- I have read the accompanying summary of business versus hobby rules. I would like to treat my activity as a hobby for income tax purposes. I understand that all my income from the activity must still be reported and my ability to take deductions will be limited.

TAXPAYER SIGNATURE

DATE