

Avoiding Business & Investment Expenses Being Classified as Hobby Losses

As you may be aware, the IRS has rules that limit the deductibility of losses from a hobby or activity not engaged in for profit. These rules do not necessarily mean that you can not deduct expenses for an activity you enjoy. However, in order to maximize your deductions, you must be prepared to show that the activity is a business from which you intend to make money. You do not actually have to make a profit, but you do have to be able to show that you have a profit motive as one of the motives for participating in the activity.

It is not that the IRS is concerned with your personal enrichment per se. Instead, the focus of the IRS is on the amount of tax revenue it takes in. Encouraging taxpayers to produce profits results in more revenue for the IRS. Activities enjoyed merely for emotional, spiritual, or intellectual, rather than fiscal improvement, on the other hand, are much more likely to produce losses rather than a profit. If all such expenses from these activities were deductible, it would actually result in decreased revenue for the IRS. Not surprisingly then, the IRS will not hesitate to disallow deductions that it concludes are hobby losses.

What does this distinction mean to you? If the IRS determines that your activity is not profit-driven, your deductions will be limited to the amount of income the activity generates. This means you can not use a loss from that activity to offset other income, such as salary or investments, resulting in your extra expenses providing you with no tax benefit. In order to have a usable loss, it is important that you be able to satisfy to the IRS that the activity was indeed established with the intention of making a profit.

In order to make sure you are properly claiming all of the deductions available to you, and to shore up your position in the event of an IRS audit, it is important to review this matter now rather than later. Converting personal expenses into business expenses by properly establishing your activity as a business can usually be accomplished. However, delaying the project can lead to lost tax savings or a hefty tax bill in the event of an IRS audit and a determination that your business was a hobby.

If you would like to discuss this matter further or if you are currently involved in, or considering, an activity that could present a hobby versus business issue, please contact our office. We would be happy to review your options for creating a new activity or documenting your existing activity as a business in order to maximize your tax savings and reduce your risk on audit.