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▪ Differences Between For-Profit Activities and Hobby Activities ▪

Dear Clients, Colleagues, and Friends:

Sometimes the Internal Revenue Service will disallow a loss because it believes the loss is really from a hobby and not a bona fide business. Certain activities tend to be questioned by the IRS more than others. Some of the IRS's favorite targets include farms and ranches, expenses associated with book writing, arts and crafts, and tournament fishing. If an activity does not make profits within certain time frames, the IRS may assert the activity is for personal purposes rather than for profit. This Newsletter lists the nine factors the IRS uses to help determine if a loss is from a business or a hobby.

Nine Factors to Determine Whether an Activity is for Profit

Whether a taxpayer is engaged in a for-profit activity ultimately depends on whether that taxpayer has good faith intent to operate for profit. Since individual intent is a subjective matter, courts try to objectively evaluate the taxpayer's intent by using a multitude of factors. Though these factors help provide insight into how an activity should be categorized, no single factor is determinative. The factors are:

1. ***Manner in Which the Taxpayer Carries on the Activity***
If the taxpayer engages in the activity in a businesslike manner, it suggests the activity is for profit. Operating in a businesslike manner involves keeping accurate records of all transactions, expenses, and revenues as one would do when operating a business. Conversely, if the taxpayer keeps incomplete records or does not maintain records at all, it suggests the activity is a hobby.

2. ***Expertise of the Taxpayer or Advisor***
If the taxpayer undertakes significant studies to succeed in the activity, this suggests the activity is for profit. Alternatively, consulting with an expert in the field about the activity and subsequently making use of that advice also suggests the activity is for profit.

3. ***Time and Effort Expended by the Taxpayer in Carrying on the Activity***
If the taxpayer spends a significant amount of personal time carrying on the activity, it suggests the activity is for profit. However, the taxpayer does not have to spend all free time engaged in the activity for it to qualify as for profit.

4. ***Expectation that Assets Used in the Activity May Appreciate in Value***
If the taxpayer has a justifiable expectation the assets involved with the activity will appreciate in value, this suggests the activity is for profit.

5. ***Taxpayer's Success in Carrying on Other Similar Activities***
If the taxpayer has had financial success while carrying out similar activities in the past, it suggests the taxpayer is operating for profit. This may be true even if the activity is not presently profitable.

6. ***Taxpayer's History of Income or Losses with Respect to the Activity***
If the taxpayer has realized income from the activity for a period of time, it suggests the taxpayer is operating for profit. However, if the taxpayer has incurred losses for a period of time that cannot be reasonably explained, it suggests the taxpayer is engaging in a hobby activity.

7. ***Profits Actually Earned and Possibility of Ultimate Profit***
If a taxpayer rarely makes notable profits, and losses are usually large, it suggests the activity is just a hobby. This factor can be differentiated from the preceding factor in that it looks at the magnitude of profits and losses, and not simply whether the activity has generally been a profitable endeavor.

8. ***Taxpayer's Financial Status***
If a taxpayer does not generate significant income or capital from other sources, it suggests that the taxpayer is relying on the activity as a source of income and that it is a for-profit activity. However, an activity need not be the sole activity a taxpayer is engaged in – or even the most significant activity – for it to qualify as a for-profit activity.

9. ***Elements of Personal Pleasure or Recreation***
If a taxpayer has recreational or personal motives for engaging in the activity, it suggests that the activity is a hobby. However, this does not mean that the taxpayer cannot derive some enjoyment from the activity. As long as there are additional, profit-oriented motives for engaging in the activity, this factor can be satisfied.

Conclusion

The tax benefits for a loss from a for-profit activity are typically much greater than those for hobbies. This is why the matter is so frequently contested with the IRS. The ultimate factor in differentiating between a for-profit activity and a hobby is whether the taxpayer has the intent to operate for profit. This intent is evaluated using a series of objective factors to determine how the activity should be classified.

If you have any questions or would like further information regarding for-profit and hobby activities, please contact us via email at **paul@paulhburgess.com** or by phone at **918-599-7755**. For information about other tax, accounting, business, and estate planning topics, see our website at **paulhburgess.com** or by scanning the **QR Code** in the letterhead.