

For Profit or Hobby?

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What we'll cover.....

- Basic hobby loss rules
- For-profit determination factors
- Order of deductions
- For-profit presumption
- Self-employment tax discussion
- Wrap up and ways to avoid common 'traps'

Basic Hobby Loss Rule

- No absolute definition
- Expenses related to production of income are generally deductible against unrelated income (IRC §212)
- Expenses are only deductible if activity qualifies as a trade or business (IRC §162)

For-Profit Determination Factors

The 9 Factors

1. Manner in which the client carries on activity
2. Expertise of the client or their advisors
3. Time and effort expended by client in carrying on activity
4. Expectation that assets used in business may appreciate in value

For-Profit Determination Factors

5. Success in carrying on similar or dissimilar activities
6. History of income and losses for activity
7. Amount of occasional profits earned, if any
8. Financial status

For-Profit Determination Factors

9. Elements of personal pleasure or recreation



Let's Put This Into Practice

- New client starts a business and loses about \$15,000 in the first few months
- Has a business plan
- Is advertising
- Has a budget
- Has all receipts
- No separate bank account
- Is selling their product for more than their cost



What Do You Think?

The hard part is that the result could go either way-----you have to be comfortable with your decision and be able to defend it...



If We Determine Activity is a Hobby

Report Income on line 21 of 1040

- On line 21 you can subtract a consistent and reasonably allocated cost of goods sold

- If net income still remains.....

If We Determine Activity is a Hobby

Tier I Expenses on Sch A

Those expenses that are otherwise allowable

Real Estate Taxes

Mortgage Interest

If net Income still remains.....

If We Determine Activity is a Hobby

Tier II Expenses on Sch A (misc itemized)

Those expenses that are typical
operating expenses

If net Income still remains.....

If We Determine Activity is a Hobby

Tier III Expenses on Sch A (misc itemized)

Those expenses that would result in a reduction in basis (depreciation)

Net result cannot be less than \$0.....

For-Profit Presumption



- 3 out of 5 years
- 2 out of 7 for horse activities

- For-Profit Presumption Election
 - Form 5213

**Election To Postpone Determination
as To Whether the Presumption Applies That an
Activity Is Engaged in for Profit**

OMB No. 1545-0

► To be filed by individuals, estates, trusts, partnerships, and S corporations.

Name(s) as shown on tax return

Identifying number as shown on tax

Address (number and street, apt. no., rural route) (or P.O. box number if mail is not delivered to street address)

City, town or post office, state, and ZIP code

The taxpayer named above elects to postpone a determination as to whether the presumption applies that the activity described below is engaged in for profit. The determination is postponed until the close of:

- The 6th tax year, for an activity that consists mainly of breeding, training, showing, or racing horses or
- The 4th tax year for any other activity.

after the tax year in which the taxpayer first engaged in the activity.

1 Type of taxpayer engaged in the activity (check the box that applies):

Individual Partnership S corporation Estate or trust

2a Description of activity for which you elect to postpone a determination

2b First tax year you engaged in activity described in 2a

Under penalties of perjury, I declare that I have examined this election, including accompanying schedules, and to the best of my knowledge and belief, it is correct, and complete.

(Signature of taxpayer or fiduciary)

(Date)

(Signature of taxpayer's spouse, if joint return was filed)

(Date)

(Signature of general partner authorized to sign partnership return)

(Date)

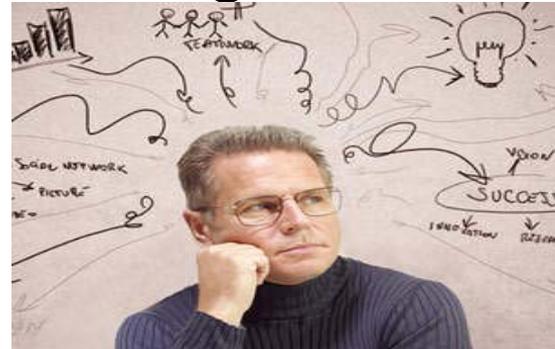
(Signature and title of officer, if an S corporation)

(Date)

Other Entities

- Hobby loss rules don't apply to C corps
- Rules do apply to partnerships, S corps, estates, and trusts

- Imagine impact on pass-through entities



Business Plans

Business plans are one more way to establish a for profit motive

- Executive Summary
- Business Description
- Product or Service
- Market Analysis
- Strategy and Implementation
- Website Plan Summary
- Management Team
- Financial Analysis

Self-Employment Tax

**Just because there is profit...
does this mean we must pay SE tax?**

- Key: Continuity and Regularity

Wrap up.....Avoiding Common Traps

Part I Income

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked ▶ <input type="checkbox"/>	1		
2	Returns and allowances	2		
3	Subtract line 2 from line 1	3		
4	Cost of goods sold (from line 42)	4		
5	Gross profit. Subtract line 4 from line 3	5		
-		-		

Wrap Up....

- Annual determination of facts and circumstances
 - You must talk to your client
- Paper your File
- How to handle issued 1099's if you determine activity is not engaged in for profit
- Review cases involving other taxpayers in your client's activity