HOBBY LOSSES

All income earned by a US tax resident must be reported, however earned. Expenses incurred in creating the income may be tax deductible. The question arises, how is particular income reported and how may expenses be claimed. For homesteaders, who may be raising food for their family, income may be earned as a side bar to that activity. For example, I may have a few extra eggs which I sell to friends and neighbors. That is income, which needs to be reported on a tax return. If I am NOT selling eggs with the intention of making a profit, then that is considered a “hobby”. If I have an activity that is a “hobby” then prior to 2018, I could take a deduction for expenses incurred in creating those eggs (a portion of feed, housing, egg cartons etc) as an itemized deduction, but from 2018 to 2025 those expenses are no longer deductible. If income is earned in the context of a profitable enterprise, all expenses incurred may be offset against the income earned from that activity AS WELL AS, other income.

So the question is, when is an activity considered a profitable enterprise or business and when is it considered a hobby. This is a facts or circumstances test i.e. what does the taxpayer intend. The IRS has created a “safe harbor” test under section 183 which basically says that an activity is NOT a hobby if it makes a profit in 3 years out of 5 consecutive years. If you do not meet this test, it doesn’t mean you are a hobby, it just means you do not have the benefit of the “safe harbor” and as such may be challenged by the IRS. The IRS considers the following factors in determining whether or not you are engaged in a business:

1 Do you carry on the activity in a business like manner?
2 Is the taxpayer an expert or an advisor?
3 Does the taxpayer devote the necessary time and effort to make the activity successful?
4 Are appreciable assets being created?
5 Are there successes in similar activities?
6 What is the history of the activity income or loss?
7 Have there been occasional profits?
8 Is the activity stable financially?
9 Is the activity undertaken for personal pleasure or recreation?

While these factors are informative, they are not necessarily determinative. So, for example, I had a client who showed a tax loss for 14 years in a row. When challenged by the IRS, we were able to show that during that period of time the taxpayer had continued to build assets, and, in fact, had “made” over $6 million dollars. He just had not chosen to realize the profits by selling the assets. The point being you are required to have a profit motive but the IRS cannot force you to realize those profits in any specific year.

Planning activities

Given the IRS safe harbor rules, is there a way we can take advantage of these? The obvious thing for taxpayers to consider when starting is to report the income, as required, but claim expenses in a manner that does not give rise to a loss. If the first three years of an activity you show a $50 profit, then in years four and five, you can show a loss. Recordkeeping will be vital to support these claims on your tax return. In addition, a taxpayer is going to want to create and maintain documents that support a positive response to the nine factors mentioned above. Do you have a separate bank account? Do you have a business plan? Do you have liability insurance? Have you informed yourself as to how to be successful in the activity – have you attended seminars or sought “professional” advice? At the end of the day, whether or not you truly have entered into an activity with the expectation of making a profit is a matter of your intentions. The IRS cannot prove your intentions, they can only show that your actions may not seem to give rise to the level of “intention to make a profit”. So while it is self-serving to create the documents necessary to meet this objection by the IRS, it will be necessary to achieve a successful tax result.

For homesteaders, there is the additional factor that you may not be involved in a single business. I have one client with 9 separate businesses. Each is completely independent of the other but a few may be loosely related. With respect to factor 3 – if one of his businesses has multiple losses, can he show that he has spent sufficient time to support his claim to be engaged in the activity with the expectation of making a profit? That could be a challenge but one that can be met.

All this to say, the question is – what is the activity in which you are engaging to make a profit? Are you selling goats? Are you selling cows? Are you selling honey? Are you selling meat birds? Are you putting on courses about how to process chickens? Are you developing content to become a media content provider? The important thing to do is to document, document, document. And guess what? Intentions change. I may start a business to sell live chickens, I may change that to sell eggs, I may change that to process chickens and sell meat, I may change that to offering courses at my facility to teach others how to process chickens for meat for a fee. I may change that to develop online content showing people how to process chickens. Each of these may be an activity I enter into to make a profit. But over time the business may change. Parts may grow and parts may die. In order get the best tax result, you need to document “why” you changed. What was the business reason for the change. It could be as simple as – I wasn’t making enough money with the way I was doing things in the past. In fact, none of the activities I just listed may be sufficient to be “profitable” by itself but the conglomeration of all things chicken may be.

To get the best result, work with your tax advisor and be sure to keep him/her informed of your plans and ask for guidance on what documentation you may need.