

9 Ways to Determine if a Client's Venture is a Business or a Hobby

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Columnist

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Have you ever taken a close look at your clients' ventures to determine if they are operating a for-profit business or if the business is merely a hobby?

Clients will always tell you it's a for-profit business; however, the IRS doesn't take a taxpayer's statement of intent as the sole factor. There must be other factors to rely on besides a taxpayer's verbal statement. Often, a taxpayer earning more than \$100,000 at his or her job will develop a "hobby" and claim they operate a business, so they can attempt to deduct their losses and reduce other taxable income.

The business-versus-hobby issue has been problematic for the IRS. Now, more than ever, the agency is beginning to scrutinize tax returns with losses, especially those with multiyear losses.

On Sept. 27, 2007, the Treasury Inspector General for Tax Administration (TIGTA) issued a report stating that significant challenges exist in determining whether taxpayers with Schedule C losses are engaged in tax abuse. The review looked at high-income, self-employed taxpayers who had income of \$100,000 or more and filed a Schedule C with losses on their tax

return. The report stated that many of the Schedule C businesses were not-for-profit, resulting in \$2.8 billion in taxes avoided in 2005. Of the tax returns prepared in this area, 73 percent were prepared by tax professionals.

Does this mean that tax professionals are taking their clients' statements at face value and not conducting sufficient due diligence to consider other factors that may provide a better determination of their clients' venture?

A taxpayer operating a for-profit business under Internal Revenue Code Section 162 should be able to prove that a bona fide business exists. It is presumed that a taxpayer is operating a for-profit business if there is a profit in three years out of a five-year period. If the taxpayer is operating a horse business, there should be a profit in two years out of seven years.

However, there is not a single factor that determines if a venture is a bona fide business or a hobby. Some businesses take more time than others to become profitable, and in the current economic climate, many businesses still struggle to turn a profit. As a result, *not* turning a profit is not the sole determining factor.

The IRS and tax courts use the following nine factors to determine if a taxpayer is operating a for-profit business or if the business is a hobby being used to deduct expenses for tax-avoidance purposes:

1. The manner that a taxpayer carries on an activity.
2. The expertise of a taxpayer or advisor(s) involved in the business activity.
3. The time and effort a taxpayer allocates to the activity.
4. Has the taxpayer had success with similar or dissimilar activities in the past?
5. The history of income/loss for the activity.
6. Are there occasional profits, and if so, how much are they?

7. The financial status of the taxpayer – does the taxpayer rely on this business activity, or does the taxpayer have other sources of income?
8. Is there an expectation of asset appreciation for any assets involved in the business activity?
9. Are there elements of personal pleasure or recreation?

Not one factor of the nine will be a determining factor. Consideration should be given to *all* factors in making a proper determination. Each taxpayer is unique and shouldn't be compared to another taxpayer. For example, not every taxpayer will allocate the same amount of time, and not every taxpayer will have the same background, education, or financial resources to allocate to their venture.

If a taxpayer's activity has ongoing losses and doesn't turn a profit in three out of five years, the IRS may conduct an audit and make a determination that the activity is a hobby. The accountant should look to see if the losses are due to circumstances out of the control of the taxpayer, if they are due to startup expenses, or whether the losses are because the activity is a hobby. If a loss occurs in multiple years, you should look to see if the taxpayer has made any changes to the operations to improve profitability or if the taxpayer is continuing to operate the same way year after year.

In addition, other considerations should be given to the type of activity and whether it is one that happens to take more time than normal to turn a profit, particularly in a recession economy. Furthermore, in evaluating the activity, questions should be asked of the taxpayer, such as whether the taxpayer acquired a loan to start up the business or for operating capital. Would anyone operating an activity as a hobby get into debt and personally guarantee a loan just to create a loss? There are so many factors to consider and use for a favorable argument of the taxpayer's activity.

As mentioned earlier, the report released by TIGTA states that a large number of taxpayers file a Schedule C with losses on their tax return to offset other income. If the determination is made that an activity is not-for-profit, the losses will not be deductible. Therefore, offsetting other income will not be allowed. The hobby-loss rules limit deductions to the extent of income from the activity. Hobby-loss limits under Code Section 183 apply to individuals, estates, S corporations, partnerships, and trusts. The loss limits do not apply to C corporations.

If a taxpayer is placed under audit for this matter and the IRS determines that the activity is a hobby, the taxpayer can make an election under Code Section 183(e) to postpone the determination by filing Form 5213 (<http://www.irs.gov/pub/irs-pdf/f5213.pdf>), *Election to Postpone Determination as To Whether the Presumption Applies That an Activity Is Engaged in for Profit*. The election will postpone the determination of the hobby presumption until the close of the fourth taxable year, or the sixth taxable year for horse activities. If the election is made, the taxpayer may continue to file tax returns in the interim, on the assumption that the activity is for-profit. An election made by a partnership or an S corporation is binding upon all partners or shareholders associated with the entity.

As taxes continue to increase in the coming years, taxpayers will try to reduce their taxable income by filing a Schedule C with losses. As a tax professional, you should conduct due diligence for taxpayers who file a Schedule C on their tax return, making sure that they are operating a for-profit business and not a hobby. Always be cautious and aware of the ramifications of making an incorrect determination.

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By [lstegemiller \(/profile/lstegemiller\)](/profile/lstegemiller) ⌚ Feb 3rd 2016 08:04

Thanks for your article Andrew! It was really interesting and intriguing read. Definitely some great food for thought. Thanks again for posting

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More Boards Count on Internal Audit to Identify Risks

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Columnist

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Corporate board members now rank reputational risk an even bigger overall concern than they have in the past three years, according to the sixth annual *Concerns About Risks Confronting Boards* [survey](http://www.eisneramper.com/uploadedFiles/Resource_Center/PDF/2015-2016%20Concerns.pdf) (http://www.eisneramper.com/uploadedFiles/Resource_Center/PDF/2015-2016%20Concerns.pdf) from CPA firm EisnerAmper LLP.

But board members – the strategy-setters for organizations – often take little action to manage various types of risk, and 71 percent of public company directors say they rely on internal audit to identify risks, the survey reveals. The traditional use of internal audit, however, is evolving into “operational audit” to monitor overall risks rather than just “the books.”

While risk management may fall to daily operations, “there seems to be little happening at the board level to encourage addressing the risks in a more comprehensive fashion,” the survey states.

“Reputational risk is a severe threat to all companies, yet responses from board members indicate that reputational risk is so broad in scope – highly impacted by other risks like financial, product, cyber, and more – that it is

difficult to sufficiently address and prepare for the many types of reputational threats,” Steven Kreit, an audit partner at EisnerAmper who leads the survey project, said in a prepared statement.

Further, only 6 percent of board members think they have a handle on social media risk (<http://www.accountingweb.com/practice/practice-excellence/social-media-risk-is-a-concern-for-internal-auditors>), yet social media and cybersecurity are directly tied to company reputations, and boards should consider both among the most important risks to monitor, said EisnerAmper CEO Charly Weinstein.

However, a majority (70 percent) of respondents on public company boards do recognize cybersecurity as a key specific risk.

“It is becoming increasingly evident how connected reputation, cybersecurity, and social media are in relation to risk,” Weinstein said.

So, where does internal audit enter the picture?

Naturally, the majority of public company board members indicated they have an internal audit function, though 22 percent said they didn’t. But almost half of private and not-for-profit organizations said they didn’t have an internal audit function.

Many respondents associate “audit” with the more traditional financial audit and not with company operations. Yet, it’s operational internal audit that can cover far more company risks than financial audit, the survey states.

“While financial regulation may have dominated many companies’ audit concerns for the past decade or two, stemming from headline news like Enron and Madoff, growing operational risk should evolve boardroom discussions to consider the scope of their organizational audits and the need to review operations,” the survey states. “The new generation of crises may impact financials, but they will likely not originate in ‘the books.’”

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