

The IRS Asks: “Is It A Real Business or Monkey Business?”

By Doug Smith

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Introduction

The question of whether you have a business or a hobby is a serious concern of the Internal Revenue Service (IRS). Here are the guidelines that the IRS uses to make that determination.

I'm not a Certified Public Accountant (CPA) or a tax professional. These guidelines are freely available from the IRS website at <http://www.irs.gov> (there may be an update by the time you read this). For help with their interpretation, I consulted "A CPA's \$10,000 Tax Refund" written by Jeff Parrack, CPA. I quoted his explanations of these guidelines with his permission. This article is for informational purposes only.

Business or Hobby?

The IRS considers many factors when determining whether you are carrying on an activity for profit. No single factor is decisive. The IRS will use the nine guidelines listed below to determine if you have a business or a hobby.

The Guidelines

1. The manner in which the taxpayer carries on the activity.

"IRS lists the following factors as evidence that an endeavor is being managed in a businesslike manner with a profit motive.

- * keeping careful books and records
- * utilizing new business operating methods rather than old, non-profitable ones
- * duplicating the successful practices of profitable businesses
- * seeking to improve and enhance the endeavor's products

and services

- * attempting to cut costs and thereby improve and increase income and therefore profit"

2. The expertise of the taxpayer or the taxpayer's advisors.

"IRS acknowledges a taxpayer's efforts to educate himself regarding the undertaken endeavor, including:

- * educating one's self through the study of books and magazines
- * attending seminars, trade shows, and other related meetings
- * joining related organizations and associations
- * consulting with known experts"

3. The time and effort expended by the taxpayer in carrying on the activity.

"If it can be shown that the taxpayer dedicates a large amount of time to attend to the normal affairs of the endeavor, a profit motive is highly indicated. Obviously, if it is the taxpayer's only line of work, the IRS will have a difficult time declaring the endeavor a hobby. IRS seems to put more weight on this guideline than any other, and rightly so, as you can imagine."

4. The taxpayer's expectation that assets might appreciate in value.

"Some businesses will demand a significant investment in assets. In some businesses, such as real estate that is owned by the taxpayer and rented out, profits may not be realized in any of the business's normal years of operation until a sale of real estate occurs. Many taxpayers invest in rental real estate with the expectation that it will appreciate in value and thereby significantly offset and outweigh the tax losses in preceding years. Such expectation of increase in value is another evidence of profit motive."

5. The success of the taxpayer in carrying on other similar or dissimilar activities.

"Many business owners branch out and expand their business holdings and investments into areas where they may have no experience. They may also expand their business empires into similar activities. If so, an argument can be made that past successes in any kind of business gives the taxpayer experience in the business world and that a desire to enter into a somewhat unknown line of business is quite normal."

6. The taxpayer's history of income or loss with respect to this activity.

"IRS' opinion is that 'a continuing lack of profits, other than in the initial stages of a venture, may indicate that an activity is not engaged in for profit.' Internal Revenue Regulation 1.183-2(b)(6)."

7. The amount of occasional profits, if any, which are earned.

"Even small profits earned in prior years will benefit a taxpayer whose 'profit motive' is challenged by the IRS. Bear in mind that even when no profits are earned, if the taxpayer can show that he meets several of the other guidelines discussed here, then the IRS will have a difficult time denying the losses it is challenging."

8. The financial status of the taxpayer.

"It should be easily apparent that if the business venture in question is the only means of support for the taxpayer, then a profit motive should be easy to justify. But what if the taxpayer has other means of support? If the taxpayer has other sources of income and is not totally dependent on the questioned venture for support, then can IRS justify a claim that such a venture is really a hobby and not a business?"

"Often, just the opposite is the case. It is obviously a lot easier for a taxpayer with additional sources of income to finance the startup of a fledgling business. Initial startup capital is quite often needed to finance the beginning of a business, and it is always easier for a person with access to money to start up a new business than it is for someone with little or no ability to dip into a savings account or to borrow money to do so."

9. The elements of personal pleasure or recreation.

"This guideline often coincides with the taxpayer's personal use of the assets of the business. For example, a person who buys a condo in the mountains and uses it during the ski season for personal pleasure and then 'rents' it out a few times the rest of the year may find it difficult to justify a claim of a profit motive."

"On the flip side, the lack of personal use of such an asset will weigh heavily in the taxpayer's favor if IRS attacks the business claim. If that same taxpayer mentioned in the previous paragraph has no desire to snow ski or spend time at the questioned condo, then a business claim is bolstered by his lack of personal enjoyment derived from the asset."

It's Not As Hard As It Looks

What have we learned? Keep your profit motive high,

document your business time and expenses, and stay organized. You'll have a huge jump on next year's tax return!

You can see that there are many gray areas to consider. Once you're aware of these guidelines, you've taken the first step to maximizing your business's tax situation.

Discuss these IRS guidelines with your tax professional so that you can devote your time to running your business, not proving to the IRS that you have one!

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