Avoid Being an IRS Target When Your Business Loses Money

If you operate what you think is a business, but that business loses money, it may not be a business at all under the tax code. Such a money-losing activity can look like a tax shelter to the IRS, and that substantially increases your chances of an IRS audit.

The tax code contains a business loss safe harbor that's known as a presumption of profit. You meet this safe harbor when your activity produces a profit in three of five years (two of seven for breeding, training, showing, or racing horses). When you meet the safe harbor, you are presumed a business unless the IRS establishes to the contrary.

We know this for-profit tax code section as the hobby loss section. But you can see that this tax code section creates trouble for much more than what you would consider a simple hobby. Here's an example of how badly the recent tax reform under the Tax Cuts and Jobs Act can treat a business that loses money.

Example. Henry has an activity that fails the business test and loses money. Last year, he had $70,000 of income and $100,000 of expenses. Under pre-tax-reform law, Henry could claim the hobby-related business deductions up to the amount of his income. So Henry deducted $70,000 (subject to some minor adjustments) and reported close to zero taxable income.

Not this year. Tax reform is going to make Henry suffer. With the same facts, Henry's business deductions are zero. His taxable income is $70,000. Think about that. Henry lost $30,000 ($70,000 - $100,000) in real money. He now pays taxes on $70,000 of phantom income.

What can Henry do to make this problem go away? He has two choices.

- First, he could create a "for profit" business defense in the hope that he would defeat the IRS in an audit.
- Alternatively, he could stop the taxation on his phantom income by operating his activity as a C corporation.