

## IS IT A BUSINESS OR A HOBBY?

In general, taxpayers may deduct all ordinary and necessary expenses in conducting a trade or business. An ordinary expense is an expense that is common and accepted in the taxpayer's trade or business. A necessary expense is one that is appropriate for the business. Generally, an activity qualifies as a business if it is carried on with the reasonable expectation of earning a profit.

To make this determination, the following factors are considered:

- Does the time and effort put into the activity indicate an intention to make a profit?
- Does the taxpayer depend on income from the activity?
- If there are losses, are they due to circumstances beyond the taxpayer's control or did they occur in the start-up phase of the business?
- Has the taxpayer changed methods of operation to improve profitability?
- Does the taxpayer or his or her advisors have the knowledge needed to carry on the activity as a successful business?
- Has the taxpayer made a profit in similar activities in the past?
- Does the activity make a profit in some years?
- Can the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?

The IRS presumes that an activity is carried on for profit if it makes a profit during at least three of the last five tax years, including the current year -- or at least two of the last seven years if the activity consists of breeding, showing or training race horses.

### Why is this an important question?

If the activity is not for profit, losses from that activity may not be used to offset other income. An activity produces a loss when related expenses exceed income. The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts and S corporations. It does not apply to corporations other than S corporations.

Further, all the gross income from the not-for-profit activity must be claimed as income and none of the expenses related to that activity are deductible.

If we can assist you with tax or business planning, please give us a call.