

Business Losses

What

The IRS is stepping up efforts to prevent taxpayers from declaring losses on activities that are not run to make a profit. Research shows that incorrect deduction of hobby losses cost the government billions per year.

The tax rules

- If your business is engaged in for profit, ordinary and necessary expenses are deductible from the income, and a taxable profit or a deductible loss might be created.
- If your business is not engaged in for profit (hobby), income is taxed in total and expenses are not deductible. This is true for tax years 2018-2025 under the Tax Cuts & Jobs Act. Prior to 2018, hobby expenses were allowed as a miscellaneous itemized deduction up to the amount of income received.

The presumption of profit

If a business is profitable in at least 3 of the last 5 years, including the present year, the IRS presumes it is engaged in for profit. If the business is engaged in breeding, training, showing or racing horses it needs to be profitable in 2 of the last 7 years to be presumed profitable.

Factors to consider

With Congress and the IRS hot on reducing revenue losses, you should be aware that your unprofitable business could be reclassified as a hobby. To determine whether your business is a hobby, the IRS asks you to consider the following factors:

- Does the time and effort put into the activity show intention to make a profit?
- Do you depend on the income from the activity?
- Have you changed your methods of operation to improve profitability? Do you have the knowledge to make your business successful?
- Have you made a profit in the past?
- Can you expect a profit in the future?

It would be wise to invest a little effort in growing your business to profitability.

Steps you can take

To be considered a business, your unprofitable endeavor has to look like a business. The following list of steps could help you run your business in a businesslike manner.

- Obtain a business license.
- Print business cards, stationery, and invoices.
- Open a separate bank account for the business.
- Keep a formal set of books.
- Document your business activities on an appointment calendar.
- Advertise your business.