



Is Your Business A Business Or A Hobby?

It really doesn't matter how **you** think of your business; the ultimate test is what the IRS thinks!

The usual question that I get from owners starting out in business is, "Will I in trouble with IRS if I lose money?"

My answer, particularly if we have a startup business, is "No. Don't worry about it. IRS recognizes that many businesses lose money when they first get started."

You have no idea how much pressure that removes from the startup owner. And in truth, many startup owners have more pressing concerns than the IRS!

IRS will get concerned when they get the feeling that the business owner is really trying to lose money. And you know what—as a responsible taxpayer myself—I want IRS to make this distinction.

While I'm willing to shoulder my share of the nation's tax burden, I'm really not interested in taking on someone else's! I want the Service to crack down on those who are really trying to work the system.

So how does IRS go about distinguishing those whose hearts are pure but nevertheless lose money, and those that are deliberately scamming their taxes?

That question is not as easy to answer as it sounds—there are many types of businesses, and many types of business owners. Creating a simple litmus test—this one is OK; that one is not—is probably impossible.

The IRS website offers two areas of guidance of what they look for. One area lists 8 factors. Here are some of the main ones.

The 8 Factor Assessment

- 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?
- Are losses beyond the taxpayer's control, or do they come in the startup phase?
- Have methods changed to improve profitability?
- Does the owner know enough about this business to be profitable?

The Profit Assessment

A second area they look for simply is profitability. Did the taxpayer make a profit in 3 of the past 5 years? That's pretty cut and dried.

They go on to say that profits in two of the past seven years are acceptable for those involved in breeding, showing, training, or racing horses.

Net Operating Losses

If your business has gross revenues of \$50,000 but it has expenses of \$60,000, you have a Net Operating Loss (NOL) of \$10,000.

And let's say, for the sake of argument, that you can prove all transactions—the \$50K in as well as the \$60K out.

You may very well be able to report this loss as an offset against other income, and therefore see a significant improvement in your tax picture.

There are a number of situations, however, when some or all of this NOL may not be deductible, so don't count on deducting your NOL without checking with someone first.

But don't count on going to that well too often! That's really what IRS is saying, and justifiably so. Keep reporting losses year after year, and therefore generating an extra boost to your tax deductions, and you just might be asked to prove that you're a business.

If IRS rules you're really not a business, then the activity is recategorized as a hobby. You still must report all the money you received as income, but they're going to start limiting the deductions you can take.

So guess what? Your former money-losing activity that gave you such a nice tax deduction becomes a money-making activity that produces more taxes for you to pay.

Precautions To Take

You probably can guess the Number One Precaution: keep good records. We hear that in legal issues, insurance claims, and similar matters. Basically, can you prove it?

Good record-keeping must be an essential of any business. If you don't have paperwork proving you bought \$20,000 of materials to sell to others, how can you expect anyone to believe you?

Here's another for the home-based business, particularly if that business is a startup and probably losing money.

Paint your name and logo on the wall of your home business. You're sending a clear message to yourself, your employees if any, and to your customers that you have a business.

IRS just might take the hint as well. After all, who paints their business name on the wall of their home if they are not serious about being in business?