If the IRS determines that a business is actually a hobby, its losses are termed "hobby losses" and may not be deductible, even against that year's income from the hobby. Once the IRS targets a business, its owner will have to demonstrate that the business is incurring expenses for the "right reason"—that is, to make a profit.

Many entrepreneurs extend themselves in multiple industries, especially in the current economic climate, and they are entitled to net their profits and losses among their noncorporate businesses (such as LLCs, S corporations, and partnerships).[1] A tech entrepreneur might run a brewery, or a retailer might develop a product line. While net losses should be deductible, the IRS will particularly scrutinize businesses running at a loss. If the IRS determines that a business is actually a hobby, its losses are termed "hobby losses" and may not be deductible, even against that year's income from the hobby.[2] The expenses of a "hobby loss" cannot defray income from the owner's other businesses or a future year's income from that hobby.[3]

Once the IRS targets a business, its owner will have to demonstrate that the business is incurring expenses for the "right reason"—that is, to make a profit. Otherwise, it may be deemed a "hobby." By statute, the internal motivation of the owner is put in play: Section 183 provides that deductions cannot exceed the gross income from the activity "if such activity is not engaged in for profit." The intent to turn a profit must be "actual and honest" but need not be "reasonable."[4] While self-serving statements made with hindsight are discounted, historical records of a systematic approach to the business are given substantial weight.

The accompanying Treasury Regulations enumerate nine factors that put the owner's motivation under the microscope, looking to "objective facts" over "the taxpayer's mere statement of his intent."[5] The plethora of factors can feel like a series of hurdles there to trip up unprepared business owners. However, they can instead provide owners with a roadmap to successfully demonstrate their for-profit motive.

In 2022, in *Jessica Walters et al.,* TCM 2022-17 (3/7/2022), the taxpayers showed how taking the time to contemporaneously document their business goals and activities can serve as credible evidence at trial to justify deducting losses. The Tax Court sided with taxpayers in a surprising finding that the taxpayers' partnership had a "bona fide profit objective" in a business that utilized a residential property as an environmentally-friendly "green" model home.[6] The IRS no doubt thought it was assured a win: the taxpayers appeared to have used the home as a vacation

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residence, expensed significant personal spending such as Major League Baseball season tickets, and the partnership's "green" line of business did not generate a profit over its six-year history (and appears not to have generated income at all).

The taxpayers, however, made the most of their strengths: a documented back-story, indicia of a business, and an economic recession to explain their lack of profit. One of the taxpayers had formal education in conservation, and the other took classes, guest-lectured, and had prior experience in "green" construction. The latter had a history of entrepreneurial success in the furniture industry as well as being on the board of an "eco-friendly" business removing plastic from streams. The taxpayers were able to show that they dedicated numerous hours to landscaping and marketing and kept the home ready to show. The Tax Court even approved of the thoroughness of the taxpayers' copious expense records despite observing that they appeared "replete" with personal purchases.[7] While the Tax Court did not believe that the Great Recession fully explained the history of loss over the nine-year life of the business, the Tax Court acknowledged that it may have played a role.

There are three lessons from this win. First, business owners have the opportunity to set themselves up for success in a hobby-loss case by maintaining thorough records. Second, taxpayers control the narrative: the taxpayers effectively told the story of their dedication to green construction, in large part because they were able to document many aspects, such as education, marketing, and expenses. Third, in a hobby-loss case, a wholistic narrative that harnesses every factor can overcome significant defects.[8] Despite what looked like some highly problematic facts in this case, only *one of the nine factors was found to favor the government*—the lack of occasional profits.

The IRS does not accuse successful businesses of being hobby-losses,[9] so business owners can and should be prepared to prove a for-profit motive when there is no profit. The recently updated Section 183 Audit Technique Guide instructs examiners to "be alert for the 'red flags,'" including the "nature" of the activity, "multiple several years with little or no income and large losses," "losses . . . offsetting other income," and "elements of recreation and/or personal pleasure."[10] Treating perfectly acceptable features of a for-profit business as "red flags" shows why a taxpayer must be prepared.

The nine factors—how to demonstrate each factor

The nine factors are set forth below with an example of how a business owner can prepare to succeed in demonstrating each factor, even when the circumstances are not conducive.

1. *Business-like manner:* Keep copious records of expenses, sales, contracts, potential clients, industry connections, and especially marketing efforts. Draft a written business plan, revise it to include new strategies informed by those records, and update it as the business develops.[11] While a business owner may feel like there is nothing to show for frustrated efforts, a record of those can be compelling, such as correspondence with potential clients, trade conferences that were attended, advertising, or changed plans.
2. *Expertise:* Obtain education relevant to the business. This can include prior education that led to the business owner's interest in the field and on-the-job training, including industry conferences and subscribing to industry publications. Hiring advisors that are experts either in the field or in business or finance can also demonstrate this, whether they are consultants or employees (even if their advice has turned out to be bad or if the taxpayer has good reason to depart from it[12]).
3. *Time and effort: Log the work.* Most business owners put an incredible amount of time and energy into their businesses, but it often goes unrecorded. Keep a calendar of days traveling for business, days on site, and days at conferences and meetings. If that is impractical, keep a sporadic diary recording projects and accomplishments, even if they did not generate business. When a business is growing, months can be spent working on a strategy that is abandoned; that work should be memorialized, not forgotten.
4. *Appreciating assets:* Keep a record of assets' changes in value, especially if the industry is volatile. If the value of a business asset fluctuates substantially, and then is sold at a loss, demonstrating that it had previously appreciated will support a for-profit motive. Because IRS exams can occur years after business activity, it may become difficult to document that assets sold at a loss had previously appreciated and showed promise.[13]

5. *Success in other activities:* Keep a resume of entrepreneurial activities. While this factor is ostensibly about past "success," in practice it is more about establishing a track record of entrepreneurial intent, so include all past attempts at entrepreneurship in any role in any field, regardless of success. This is particularly important if the business is a "side hustle" that might otherwise look like a hobby; a string of side-hustles can show entrepreneurial intent.[14]
6. History of income and loss: Keep a record of external events that impacted profitability. The Treasury Regulation specifically contemplates that continued losses can result from "drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions." Some businesses can suffer from multiple such events, and some businesses simply have a long start-up period, such as five to ten years.[15]
7. *Occasional profits:* Keep a record of unrealized opportunities to make a significant return on any investments. If the business receives an offer to purchase an asset, such as IP, real estate, or chattel, make a record of the offer and the reason for declining it.[16] Turning down an offer to sell at a profit because one has a business plan to further increase or leverage the asset's value may demonstrate a profit motive, despite future loss.[17] Such records can also serve as evidence that the business is a "highly speculative venture" and therefore undertaken with a motivation to earn large profits despite a low likelihood of success.[18]
8. *Financial status:* Record the owner's personal financial motivation for engaging in the business. For example, if the owner's income from other activities is variable, insecure, or illiquid, that will support the owner's profit motive, even if the owner's financial picture is strong in retrospect. A particular financial goal, such as setting up one's child in a business, can also be persuasive.[19] This is particularly important if the business is a "side hustle" that might otherwise look like a hobby financed by the owner's primary business.
9. *Personal pleasure or recreation:* Create boundaries between the owner's activities on behalf of the business and personal activities, and avoid having the business make personal purchases. Logging the owner's work will also help. Keep a record of aspects of the job that might appear unpleasant to the average person, such as when it requires dirty or dangerous work, grunt work, or hands-on management. Business owners often overlook the sacrifices they make day-to-day in their passion for their work, but that dedication shows a for-profit motive.

Recordkeeping

This recordkeeping does not have to be onerous. Some of it can be done with software and some of

[1] Section 162(a). Losses are limited to the amount "at risk" in the business activity. Section 465. Losses are also limited with respect to investment in passive activities. Section 469. *See also* Section 704 (limiting the deductibility of a partner's loss), Section 1366 (limiting the deductibility of an S corporation shareholder's loss). All statutory references ("Sections") herein refer to the Internal Revenue Code of 1986, as amended, and all regulatory references refer to the accompanying Treasury Regulations.

[2] Section 183 (with a proposed exception for "the production of steel industry fuel" as set forth in H.R. 4758 § 2(f)(1) (7/28/2021)). In 2021, the Tax Court confirmed that Section 183(b)(2) hobby losses are subject to the 2% floor on miscellaneous itemized deductions per Section 67(a), and thus may not even defray that year's income from the hobby. *Carl L. Gregory et al.*, TCM 2021-115 (9/29/2021). Even worse, for years 2018 through 2025, the Tax Cuts and Jobs Act of 2017 eliminated miscellaneous itemized deductions altogether.

[3] Section 183.

[4] *Hulter*,91 T.C. 371, 392-93 (1988) (citing numerous Tax Court cases); Reg. 1.183-2(a) ("Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit.").

[5] Reg. 1.183-2(b); *see also Keanini*, 94 T.C. 41 (1990).

[6] *Jessica Walters et al.*, TCM 2022-17 (3/7/2022).

[7] *Jessica Walters et al.*, TCM 2022-17 (3/7/2022).

[8] The list of factors enumerated in the Treasury Regulation is non-exclusive; no single factor is determinative, nor is a majority of factors necessarily determinative. *E.g., Abramson*, 86 T.C. 360, 371 (1986).

[9] In fact, the intent of the taxpayer does not come into play if the business generates a profit in three or more of the years in the five-year period ending with the taxable year at issue, due to the statutory "safe harbor" rule. Section 183(d) (also providing a more generous safe harbor for horse-related businesses—two out of seven profitable years suffices).

[10] Activities Not Engaged in for Profit Audit Technique Guide, IRC Section 183 (rev. 9/7/2021) at 10.

[11] The taxpayers in *Skolnick*, a horse racing and breeding case discussed *infra*, revised their business plan twice, but then let it sit for over five years while acquiring significant new assets, including acreage and horses without revising it, leaving them vulnerable to the Tax Court's criticism that "the plan was woefully out of date." *Skolnick*, TCM 2021-139 (12/16/2021) (on appeal to the Third Circuit, case no. 22-1501 docketed 3/24/2022).

[12] *E.g., Huff*, TCM 2021-140 (12/21/2021) (finding, pursuant to Reg. 1.183-2(b)(2), that this factor favored the taxpayers whether or not they were correct in disagreeing, based on their own experience in the field, with the expert they consulted).

it less formally, such as with a diary. It may even improve the business strategy and execution. Recordkeeping is the single best defense to a hobby-loss examination,[20] and can even result in a quick resolution at the IRS examination level without an expensive trial. An IRS examiner who is probing for weakness may decide to move on to the next case if a taxpayer provides a robust, fact-based, and documented response to that first IDR.

Naturally, not all recordkeeping is equal. While the recordkeeping of the taxpayers in *Walters* was commended despite the deduction of apparently personal expenses, certain types of records can be consistent with both a business and a hobby. In a December 2021 decision, Skolnick, the Tax Court found the recordkeeping of a horse racing and breeding activity insufficient despite "voluminous" records of its overall finances and income and expenses relating to each horse.[21]

In ruling for the IRS in *Skolnick,* the Tax Court pointed out significant failures in recordkeeping: the business owners did not keep accurate records of their ownership percentages or account for cash infusions.[22] Similarly, the business did not account for personal benefits; for example, it did not charge an owner who lived and hosted his wedding on the ranch for rent and landscaping.[23] It did not have a budget and its business plan was six years old and did not reflect the current real estate or livestock.[24] As a result, the records that were kept pertaining to the horses were consistent with dedication to a hobby, while the records that were not kept revealed a lack of business-mindedness. The Tax Court revealed the nature of the onus on the taxpayer: "Although the absence of records may show the lack of profit motive, the presence of records does necessarily not show the opposite."[25] In other words, recordkeeping is about quantity *and quality.*

Walters and *Skolnick* both demonstrate that the for-profit motive of a business involving the use of a part-time or full-time residence in a business is particularly scrutinized.[26] While *Walters* considered a business that was uniquely positioned to utilize a home—a consulting business for green home construction methods—the ranch house in *Skolnick* undercut the business purpose as its use suggested strong elements of personal pleasure and recreation (and the owner was not a hands-on rancher).

Walters suggests that businesses selling items that are ideally displayed or used in a home setting would have an advantage in justifying the use of a residence. With the seismic shift toward working from home following the pandemic, the more blurred the line between home and business has become. This creates more opportunity, but also requires more recordkeeping to demonstrate the basis for using the home in the business and the extent to which home expenses are business expenses.

The Tax Court also recently provided a reminder that combining unrelated activities into a single business to net their profit and loss in a runaround of Section 183 will not fly under the radar.[27] Reg. 1.183-1(d) counters

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[13] For example, the Tax Court determined that a horse breeding and racing operation had an expectation of appreciation based on documentation of six-figure offers to purchase horses that had been acquired for little cost, despite the fact that taxpayers rejected those offers and then suffered losses on one or more of the horses and overall losses. *Annuzzi*, TCM 2014-233 (finding, pursuant to Reg. 1.183-2(b)(4), that this factor favored the taxpayers).

[14] The IRS Section 183 Audit Technique Guide instructs examiners to "focus on activities other than the taxpayer's primary source of income," so, "[f]or example, if the taxpayer is a medical doctor, "focus on the taxpayer's success or failure in other unrelated ventures such as the operation of a restaurant or a kennel" and "determine if the taxpayer has abandoned other activities when those activities were proven to be unsuccessful." Activities Not Engaged in for Profit Audit Technique Guide, IRC Section 183 (rev. 9/7/2021) at 32.

[15] *E.g., Engdahl*, 72 T.C. 659, 669 (1979) (finding for the taxpayer where exam years were years 8-10 of the business that had generated losses in all years: "The start-up phase of an American saddlebred breeding operation is 5 to 10 years."). *Skolnick*, a horse racing and breeding case discussed *infra*, cites *Engdahl* favorably but notes that in *Skolnick* the "losses did not stop after 5 or even 10 years." *Skolnick*, TCM 2021-139 (12/16/2021) (appeal docketed, see note 11).

[16] Recording the basis for declining an opportunity to profit will also protect the taxpayer from the allegation that the opportunity was declined because the taxpayer did not care about making a profit. *E.g., Skolnick v. Commissioner*, TC Memo. 2021-139, *15 (Dec. 16, 2021) (appeal docketed, see note 11) (inferring a lack of for-profit motivation from the fact that the taxpayers declined an offer for their land but then "made no serious effort to generate income from the land").

[17] *E.g., Annuzzi*, TCM 2014-233 (2014) (finding, pursuant to Reg. 1.183-2(b)(7), that this factor favored the taxpayers based on evidence of rejected six-figure offers for thoroughbred horses which showed "a real opportunity to earn a substantial profit" though that profit was not realized).

[18] Reg. 1.183-2(b)(7).

[19] *E.g., Huff*, TCM 2021-140 (12/21/2021) (holding for "extremely wealthy [taxpayers] who wanted to supplement the income of their adult daughter" where they had "a general understanding that the operation would be hers if and when it turned a profit").

[20] The first factor under the Regulation, "the manner in which the taxpayer carries on the activity," is the most record-focused, looking for "complete and accurate books and records." Reg. 1.183-2(b)(1). In an article analyzing the *Walters* case, Peter J. Reilly reveals that after analyzing 332 opinions, he has identified "only one opinion in which the taxpayer prevailed on factor 1 and lost the case and only one opinion in which the taxpayer lost on factor 1 and won the case." "An Unusual Tax Court Hobby Loss Opinion" (forbes.com). While it may be that a finding on this factor reflects the overall conclusion rather than

such a runaround by providing that "[g]enerally the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities . . . [unless] it appears that his characterization is artificial," in which case a separate for-profit analysis is to be done on separate activities. In *Kinney*, the IRS argued that the taxpayer's Schedule C combined "disjointed activities."[28] The Tax Court noted in *dicta t*hat a taxpayer would not be "preclude[d] from arguing that they constitute one business" but agreed with the IRS that there was a question as to whether the taxpayer's "Schedule C activities" met the requirements of Section 183 "either individually or collectively."[29]

Conclusion

Despite so many technical points, at any stage—examination, administrative appeal, or litigation—an owner can obtain experienced representation to draw the enumerated factors together into a wholistic narrative that turns recordkeeping into a compelling demonstration of the owner's entrepreneurial spirit. The silver lining to a business that is not yet succeeding is that it should reduce the tax burden on an owner's other income, reducing the real cost of the start-up phase and enabling further investment in the business. With a for-profit motivation and the foresight to diligently document it, business owners can prevail in being taxed only on the net profit of their combined businesses, keep their net operating losses, and enable their entrepreneurial goals.

leading to it, there is no question that the taxpayer can powerfully set the stage with contemporaneous recordkeeping.

[21] *Skolnick*, TCM 2021-139 (12/16/2021) (appeal docketed, see note 11).

[22] *Id*.

[23] *Id*.

[24] *Id*.

[25] *Id*.

[26] Neither of these cases involved an analysis of Section 280A, which restricts deductions related to the use of a dwelling unit used by the taxpayer as a residence, and like Section 183, can preclude netting a loss against income from other sources. Depending on the factual circumstances and the nature of the deductions, both Section 280A and Section 183 may apply.

[27] *Kinney*, TCM 2022-81, n.5 (7/28/2022) (appeal to Tenth Circuit filed 10/20/2022).

[28] *Id.*, n.5.

[29] *Id.*, n.5 (declining to consider the question because all of the Schedule C deductions were found to be personal and precluded by other sections of the Code). Note: This case involved an unsympathetic taxpayer, a disbarred attorney who had been declared a vexatious litigant, and some of the expenses related to such litigation.