

Can I Deduct That?

An Overview of Hobby Losses

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Taxpayers are generally allowed to deduct losses sustained in a for-profit business against their other taxable income. However, losses generated by activities that are not engaged in for-profit are considered hobby losses by Internal Revenue Code Section 183. Expenses related to hobbies are only deductible to the extent of income produced by the activity. In addition, they are deducted on Schedule A as a miscellaneous itemized deduction, which is subject to the 2% of adjusted gross income limitation and not deductible for alternative minimum tax purposes.

To avoid being considered a hobby, the activity must be profitable in three out of five consecutive tax years ending with the year in question. Activities involving racehorses have a profit threshold of two out of seven years.

The IRS frequently challenges taxpayers on whether a particular activity is a hobby or a for-profit venture. You should consider the following steps to help establish your for-profit motive:

- Develop a written business plan that shows how the business can be profitable over time.
- Keep good business books and records.
- Open a separate checking account.
- Consult with experts in the field; document their advice and how it was implemented (or why it was not implemented).
- Document your involvement in the activity, not just hours, but how your skills help to make it more profitable.
- Document asset appreciation from year to year (if significant, this may require an appraisal).

If the activity involves an element of personal pleasure or recreation, or could be perceived as such by the IRS, it is even more important to demonstrate profit motive, carefully separating personal expenses.

If you have any questions regarding these topics, please contact Neil Lapidus at (612) 381-8720, Todd Lifson at (612) 381-8800, or Matt Brown at (612) 381-8712.

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