Hobby Losses

Taxpayers are allowed to claim losses from any activity engaged in for profit. However, for activities not engaged in for profit, taxpayers are required to report the income from the activity on Line 21 of their Form 1040 and are allowed expenses (up to the amount of income reported) as a miscellaneous itemized deduction subject to the 2% floor.

In 2007, the Treasury Inspector General for Tax Administration (TIGTA) issued a report indicating that 1.2 million taxpayers have avoided up to $2.8 billion in taxes by improperly claiming losses from activities not engaged in for profit. A subsequent report from the TIGTA Department in 2016 found that 88% of the returns they reviewed showed an "indication that the Schedule C business were not engaged in for profit." This comes from businesses with multiple reported years with losses.

The IRS TIGTA Department made two recommendations in the 2016 report:

1. IRS should make use of its research to identify high-income individual returns with multiyear Schedule C losses and other factors that indicate the taxpayers may not have a profit or capital gain motive for the activity, and
2. IRS should emphasize the importance of the required checks of filed tax returns in the preliminary determination of whether to pursue a hobby loss issue and provide tools to assist examiners in documenting their conclusion.

IRS Management agreed with the recommendations for the TIGTA Department and indicated that they plan to take corrective actions. In practical terms this translates to more examinations of Schedule C losses emphasizing the hobby loss rules.

Treasury Regulation 1.183-2(a) is the IRS interpretation of how to determine whether an activity is engaged in for profit. The underlying theme of the regulation is to set out several objective standards that can be used to make the determination. The regulation is clear that all facts and circumstances must be taken into consideration.

Treasury Regulation 1.183-2(b) provides nine separate factors to be analyzed in determining whether or not an activity is engaged in for profit. No single factor below is determinative in whether the taxpayer has the requisite profit motive.

1. Manner in which the taxpayer carries on the activity
2. The expertise of the taxpayer or his advisors
3. The time and effort expended by the taxpayer in carrying on the activity
4. Expectation that assets used in the activity may appreciate in value
5. The success of the taxpayer in carrying on similar or dissimilar activities
6. The taxpayer’s history of income or losses with respect to the activity
7. The amount of occasional profits, if any, which are earned
8. The financial status of the taxpayer
9. Elements of personal pleasure or recreation