Dear Prospective Owner,

Like many of us, you've probably dreamed of turning a hobby or avocation into a regular business. You won't have any unusual tax headaches if your new business is profitable. However, if the new enterprise consistently generates losses (your deductions exceed income), the IRS may step in and say it's a hobby — an activity not engaged in for profit — rather than a business.

What are the practical consequences? Under the so-called hobby loss rules, you'll be able to claim those deductions (such as state and local property taxes) that are available whether or not the enterprise is engaged in for profit. However, your deductions for business-type expenses (such as rent or advertising) will not be deductible. By contrast, if the new enterprise isn't affected by the hobbyloss rules, all otherwise allowable expenses would be deductible on Schedule C, even if they exceeded income from the enterprise.

There are two ways to avoid the hobbyloss rules. The first way is to show a profit in at least three out of five consecutive years (two out of seven years for breeding, training, showing, or racing horses). The second way is to run the venture in such a way as to show that you intend to turn it into a profit-maker, rather than operate it as a mere hobby. The IRS regs themselves say that the hobbyloss rules won't apply if the facts and circumstances show that you have a profit-making objective.

How can you prove that you have a profit-making objective? In general, you can do so by running the new venture in a businesslike manner. More specifically, IRS and the courts will look to the following factors: how you run the activity; your expertise in the area (and your advisers' expertise); the time and effort you expend in the enterprise; whether there's an expectation that the assets used in the activity will rise in value; your success in carrying on other similar or dissimilar activities; your history of income or loss in the activity; the amount of occasional profits (if any) that are earned; your financial status; and whether the activity involves elements of personal pleasure or recreation.

The classic "hobbyloss" situation involves a successful businessperson or professional who starts something like a dog-breeding business or a farm. But IRS's long arm also can reach out to more prosaic situations, such as businesspeople who start what appears to be a bona-fide sideline business.

Please call our offices to get more details on whether a venture of yours may be affected by the hobbyloss rules, and what you should do right now to avoid a tax challenge.

Very truly yours,

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