

## FINANCE

# Mixing Business and Pleasure

BY LINDA STERN

## How to Prove to the IRS That Your Venture Is More Than a Hobby

Jim Lockwood loves his work. And why not? A lifelong western-movie enthusiast, Lockwood travels to western conventions, mingles with his childhood idols, collects western books, videos, and artifacts, and plays dress-up on a regular basis, all in the name of his growing leather reproduction business, Legends in Leather.

"This is like living a childhood dream," says 52-year-old Lockwood, who puts in eight-hour days and is now turning a profit with his two-year-old company. "When you think about it, what guy my age has a legitimate reason for getting up every morning, strapping on two guns, and wearing spurs and a cowboy hat all day?"

### MAKE PLAY WORK FOR YOU

Lockwood is succeeding where many others fear to tread: He is turning his hobby into a profitable business. Or as he more poetically puts it, "I stepped into a world I've already been visiting a lot."

Hobbyists who become entrepreneurs have three huge advantages over their competitors: One, they have a built-in enthusiasm for the subject; two, they already know a lot about it; and three, they have a dedication to the field that can result in a superior product or service.

There is one potential downside, however. In order to take full advantage of business deductions, the IRS will need some convincing. You see, their idea of a hobby is anything without a true profit motive—whether or not you have been an enthusiast in the particular field. You must illustrate your commitment to the professionalism of your new venture. Not only is this important for tax reasons, it's

*Contributing editor LINDA STERN wrote "Trade in Your Old Way of Investing" in last month's issue.*



When you prove your profit motive to the IRS, as did western enthusiast Jim Lockwood, you can turn a hobby into a legitimate business and deduct your expenses.

also the key to eventual profitability. If you want to build a business, you have to do things that aren't as much fun as a typical hobby—create a budget, research the market, write a business plan, and sell yourself. Then you have keep businesslike records of your expenses.

### PROVE YOURSELF TO THE IRS

Tax law allows you to deduct expenses associated with money-making hobbies, even if they aren't businesses, but only up to the amount the hobby earns. Sell one photo a year for \$125, and you can't deduct \$10,000 worth of photography equipment if what you have is a hobby.

But you can deduct the equipment if what you have is a business. At least for a while. The IRS understands that people often spend more than they earn in the

early years of building a business. But for obvious reasons, the Feds frown on side businesses that generate large losses and psychic rewards for taxpayers, especially when those taxpayers have other sizable sources of income and the side businesses are things like horse breeding, sailboat renting, and antique dealing.

For legal purposes, the difference between a business and a hobby is not a profit, but a profit motive. You have to be able to demonstrate to the IRS that you're really trying to make money.

Historically, the courts have been lenient in this area. A famous case of the 1970s still provides the basis for tax law in this area. Gloria Churchman was an artist who had been painting, sculpting, and exhibiting for 20 years without ever making a

profit. She traveled nationwide to meet gallery owners, lectured about art, set up her own gallery, printed up posters and books, and happily wrote off all of those expenses, often several thousand dollars a year. She even sold a few paintings and posters, reporting no income for 1970 and 1971 and \$250 of income in 1972.

But Churchman kept trying to make money, and she kept meticulous records. And in 1977, the U.S. Tax Court was persuaded. "It is certainly conceivable in our view that she may someday sell enough of her paintings to enable her to recoup the losses, which have meanwhile been sustained in the intervening years," the court held, citing Churchman's high-energy marketing of her work and her qualifications as a locally recognized art lecturer.

PHOTOGRAPH BY PETER GLASS

## FIND SAFE HARBORS

If you make a profit in your hobby-based business, the burden of proof shifts to the IRS. To disqualify your deductions, the service has to prove that you aren't a business. This rule applies to businesses that have produced profits in three of the last five tax years. (Or two of the last seven years, if you breed racehorses.)

Yet even this test has some subjective standards. Don't think that you can take \$40,000 losses for two years and then report \$125 profits for three and escape raised eyebrows.

The IRS has made provisions for start-up businesses that show losses without the three-out-of-five-year history. You can file Form 5213, which effectively says, "Give me five years to get up and running, then come back and evaluate me."

But Susan Harvey Dawson, an Alexandria, Virginia, attorney who specializes in taxes for artists, says don't bother. "Filing that form is just like saying, 'Come over here and look at me!'" she says. "If you truly are businesslike, it's no trouble to prove without the form."

## SHOW MOTIVE WITHOUT PROFIT

To demonstrate that you have a profit motive and are a legitimate business, you have to act businesslike. The IRS has nine points its examiners consider when they determine your seriousness of intent:

- Whether you carry on the activity in a businesslike manner.
- Whether the time and effort you spend on the activity indicate you intend to make it profitable.
- Whether you are depending on income from the activity for your livelihood.
- Whether your losses from the activity are due to circumstances beyond your control or are normal in the start-up phase of your type of business.
- Whether you change your methods of operation in an attempt to improve the profitability of the activity.
- Whether the activity makes a profit in some years and how much it makes.
- Whether you, or your advisers, have the knowledge needed to carry on

the activity as a successful business.

- Whether you were previously successful in making a profit in similar activities.
- Whether you can expect to make a future profit from the appreciation of the assets used in the activity.

These nine points are used as a whole; you don't have to meet every objective as long as you meet most and pass the smell test, Dawson notes.

To act businesslike in the typical ways, keep a separate business checking account as well as meticulous records. Keep all

documents that demonstrate your intent. If you scribbled budget notes on a legal pad to get started, keep those pages. Record all trips and investments made on behalf of the business. And keep proof of your attempt to sell yourself, even

if you find the going tough. For example, a would-be writer can use a sheaf of rejection letters to prove that she has been trying to sell her work. Place ads and keep copies of them.

## FROWN WHEN YOU SAY THAT

Not listed among those nine points, but commonly believed to be an IRS consideration by tax practitioners, is the degree of satisfaction you take in your work. In other words, if you are having too much fun, maybe your work truly is a hobby and not a business.

A sad commentary, but put yourself in the place of an IRS agent. He might have to spend 40 hours a week in what Dawson calls "a confining burlap cubicle," nitpicking tax returns. He looks at yours—and your write-offs include travel expenses to beautiful places, photo equipment, and film in quantities he only wishes he had time to shoot. Rough life. Perhaps there is a little bit of resentment at play.

When you love your life's work, you have to expect some envy.

"I tell my photographer and artist clients to understand that the rest of the world looks to their activities for recreation. Only we know it's a compulsion," says Dawson.

So follow your heart, but keep a ledger. And happy trails to you! ■

## The Feds frown on side businesses that generate large losses and psychic rewards for taxpayers.



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