Hobby or Business?
Active or Passive?

By Robert Tufts, Ken Kelley and Kevin Burkett

One advantage of a business is the ability to offset losses against income from other enterprises or wages. Whether the losses are currently deductible is determined by the classification of the business.

The Internal Revenue Service considers an activity as either a hobby or a business. To be a business the owner must have "an actual and honest objective of making a profit." If the activity is a business, the owners can be either materially participating or passive.

Deducting Expenses

Active Business. If an activity is (1) engaged in "for profit," (2) owners are materially participating, and (3) expenses exceed revenue, then the losses can be deducted from other income before calculating income tax liability. For example, if a cattle operation had a loss of $5,000 on Schedule F last year and the operation was a business, the $5,000 could be used to reduce taxable income from other sources, even wages from an off-farm job.

Passive Business. If one of the owners did not materially participate, he can only deduct expenses against other passive income. For example, one of the owners may have contributed money, but he does not work in the cattle operation. He could not use the $5,000 loss to reduce taxes from wages. If that owner also had passive income from other operations, property rental is the classic passive business, he could deduct the cattle expenses against the rental income. He could not deduct passive expenses from active income. Unused passive losses are treated as a deduction with respect to the activity generating the loss in the next tax year. Code Sec. 469(b). There is no requirement that the activity generating the loss be related to the activity generating the income.

Hobby. If the operation was a hobby, sport, or for recreation, in other words, not carried on primarily for profit, the loss would be limited to taxable income associated with the hobby. In the example above, there is a net loss, so the $5,000 is not deductible. This is known as the "hobby loss" rule. Internal Revenue Code (IRC) §183.

If there had been hobby income, it would have been reported on line 21, "Other income" on Schedule 1 of Form 1040. Expenses, on the other hand, are claimed on Schedule A, mostly as miscellaneous itemized deductions [link to hobby expenses]. This means they are only deductible if the farmer itemized deductions instead of taking the standard deduction. Even worse, for tax years 2018 through 2025, the Tax Cuts and Jobs Act disallows miscellaneous itemized deductions.

Classification

For Profit. The IRS assumes that any activity that earns a profit for three out of five consecutive years is a “for profit” operation, but two out of seven for breeding, training, showing or racing of horses,. If the farmer cannot show profitability, he has the burden of proving the activity was entered into for profit, and facts carry more weight than intent. The factors that are taken into account in determining whether a taxpayer is engaged in an activity for profit are:

(1) the manner in which the taxpayer carries on the activity;

(2) the expertise of the taxpayer or his advisers;

(3) the time and effort the taxpayer puts into carrying on the activity;

(4) the expectation of the taxpayer that the assets used in the activity may appreciate in value;

(5) the taxpayer's success in carrying on other activities;

(6) the taxpayer's history of income or losses from the activity;

(7) the amount of profits (if any) earned from the activity;

(8) the financial status of the taxpayer; and

(9) the presence of personal motives in carrying on the activity (Reg. Sec. 1.183-2(b)).

Material Participation. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial. IRC § 469. Material participation is a year-by-year determination; the taxpayer must prove in each separate tax year that he materially participates. Reg. Sec.1.469-5T(a) describes the seven tests for material participation. Working in the business for 500 hours per year constitutes material participation. The other rules are ways to qualify if you do not meet the 500-hour test. The taxpayer needs to meet only one of the tests to be deemed to materially participate in an activity. The term "taxpayer" for material participation includes both spouses in the case of a married couple.

Section 1.469-5T Material participation (temporary) provides that, “an individual shall be treated, for purposes of section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if--

(1) The individual participates in the activity for more than 500 hours during such year;

(2) The individual's participation in the activity for the taxable year constitutes substantially all of the participation in such activity of all individuals (including individuals who are not owners of interests in the activity) for such year;

(3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year;

(4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours;

(5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;

(6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or

(7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual participates in the activity on a regular, continuous, and substantial basis during such year."

"Courts have disregarded travel time to an activity in calculating whether a taxpayer has materially participated in an activity where such time is analogous to personal commuting (*Goshorn v. Comm'r*, T.C. Memo. 1993-578). However, courts have allowed travel time in certain circumstances to be counted in determining material participation. For example, in *Truskowsky v. Comm'r*, T.C. Summary 2003-130, the court found that the taxpayers' travel from their home to a farm where they boarded their cattle was not time that could be counted in determining material participation; however, their travel from the farm to facilities where the cattle were receiving veterinary services was counted." Paragraph 247,115.30 Hours Not Counted in Determining Material Participation, Parker Tax Pro Library.

The IRS Passive Activity Loss Audit Technique Guide states that the following are indicators that the taxpayer did not materially participate in an activity:

(1) The taxpayer was not compensated for services. Most individuals do not work significant hours without expecting wages or commissions.

(2) The taxpayer's residence is hundreds of miles from the activity.

(3) The taxpayer has a W-2 wage job requiring 40 or more hours a week for which he or she receives significant compensation.

(4) The taxpayer has numerous other investments, rentals, business activities, or hobbies that absorb significant amounts of time.

(5) There is paid on-site management/foreman/supervisor and/or employees who provide day-to-day oversight and care of the operations.

(6) The taxpayer is elderly or has health issues.

(7) The majority of the hours claimed are for work that does not materially impact operations.

(8) Business operations would continue uninterrupted if the taxpayer did not perform the services claimed.

Passive Activity. A passive activity means any activity which involves the conduct of any trade or business in which the taxpayer does not materially participate and any rental activity unless the taxpayer is a real estate professional. IRC § 469(c). Any other type of income, while it may seem passive, is nonpassive and cannot be used to trigger passive losses. The fact that the taxpayer did not work for the income, or that the income may be designated as "passive" under a Code section other than Code Sec. 469 is irrelevant. Sometimes rental income is not passive. Reg. Sec. 1.469-2(f)(6), which is known as the "self-rental rule," provides that when a taxpayer rents property to his own business, the income is not passive activity income. There is also a special deduction [link to additional information] that allows a "natural person" to deduct up to $25,000 of rental real estate losses against nonpassive income. Code Sec. 469(i).

Generally a limited partner is treated as "passive" for the partnership. Code Sec. 469(h)(2). However, Reg. Sec. 1.469-5T(e)(3)(ii) provides that a partnership interest of an individual is not treated as a limited partnership interest if the individual is a general partner in the partnership at all times during the partnership's tax year. So, the taxpayer can qualify as materially participating in an activity under any one of the seven tests in Reg. Sec. 1.469-5T(a).

"Where a taxpayer receives income from a third party's trade or business as a result of some capital or other transaction entered into between the taxpayer and the third-party's business, the income is treated as either a capital gain or as investment or portfolio income that is not eligible to be offset by passive losses." Paragraph 247,145, Parker Tax Pro Library. Code Sec. 469 specifically excludes portfolio income from passive income.

At-Risk. The amount of loss that can be deducted is also limited by the "at-risk" rules. IRC § 465. Generally, the at-risk rules apply to all activities and the losses are limited to the amount for which the taxpayer is at-risk for that activity at the close of the tax year. The at-risk rules are designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment in an activity. A taxpayer is considered at risk for (1) money and the adjusted basis of property contributed to an activity; and (2) amounts borrowed with respect to an activity for which the taxpayer is personally liable or has pledged property. IRC § 465(b)(1). Any loss from an activity which is not allowed under the at-risk rules can be carried over and treated as a deduction in future tax years.

Conclusion

To get the maximum income tax benefit from an activity, the owner should be materially participating, and the activity should be classified as a “for profit” activity. This article is meant to provide guidance for the business owner and is not legal advice. You should consult a tax professional before making any changes to your operation.

Hobby loss expenses.

The deduction of expenses from an activity that is not engaged in for profit generally is limited to the amount of gross income derived from that activity. In other words, a loss from an activity that a taxpayer does not engage in for profit cannot be used to offset the other income of the taxpayer. In such a case, the taxpayer must take deductions attributable to the activity in the following order and only to the extent stated in the following three categories:

Category 1 Deductions: Deductions the taxpayer can take for personal as well as for business activities are allowed in full. For individuals, all nonbusiness deductions, such as those for home mortgage interest, taxes, and casualty losses, fall into this category.

Category 2 Deductions: Deductions that do not result in an adjustment to the basis of property are allowed next, but only to the extent the taxpayer's gross income from the activity is more than the deductions under the first category. Most business deductions, such as those for advertising, insurance premiums, interest, utilities, and wages, fall into this category.

Category 3 Deductions: Business deductions that decrease the basis of property are allowed last, but only to the extent the gross income from the activity exceeds the taxpayer's deductions under the first two categories. Deductions for depreciation, amortization, and the part of a casualty loss an individual could not deduct in Category 1 belong in this category (Code Sec. 183(b); Reg. Sec. 1.183-1(b)).

For individual taxpayers, these deductions may be taken only if deductions are itemized. Individuals take the Category 1 deductions on the appropriate lines of Schedule A (Form 1040). Individuals take the Category 2 and 3 deductions as miscellaneous deductions on Schedule A (Form 1040).

Rental Property

Due to depreciation, rental activities often generate net losses. Since rental activities are generally automatically passive under Code Sec. 469(c)(2) and (4), irrespective of whether the taxpayer materially participates, losses from rental activities are subject to the passive activity loss limitation rules. There are some exceptions, however. The first $25,000 of rental real estate losses may be deducted against nonpassive income by taxpayers that meet an active participation test. Also, rental real estate losses are fully deductible:

(1) on rental real estate of a real estate professional if the professional materially participates in the rental real estate activity (Reg. Sec. 1.469-9(e)(1));

(2) on the sale of a rental property to an unrelated party in a fully taxable transaction (Code Sec. 469(g)); and

(3) when the rental activity has been properly grouped under Reg. Sec. 1.469-4(d) with a business activity and the property is used in the business activity.

In the case of any natural person, a deduction of up to $25,000 ($12,500 if married filing separately) is allowed for that portion of the passive activity loss, or the deduction equivalent of the passive activity credit for any tax year, which is attributable to all rental real estate activities with respect to which the individual actively participated (i.e., the active participation standard) in such tax year (and if any portion of such loss or credit arose in another tax year, in such other tax year) (Code Sec. 469(i)(1) and (2)). Thus, the deduction is applied on an aggregate basis and not to each individual rental activity. The $25,000 (or $12,500 if married filing separately) is subject to a phaseout for individuals with modified adjusted gross income above $100,000 (or $50,000 if married filing separately). For every $2 of modified adjusted gross income that exceeds $100,000 (or $50,000 if married filing separately), the special allowance is reduced by $1 (Code Sec. 469(i)(3)(A); Code Sec. 469(i)(5)(A)(ii)). Thus, for example, when the adjusted gross income of a single taxpayer who meets the applicable requirements exceeds $150,000, the taxpayer cannot take advantage of the special allowance. At that point, rental real estate losses are deductible only to the extent of passive income (Code Sec. 469(i)(5)(A)).

The difference between active participation and material participation is that the former can be satisfied without regular, continuous, and substantial involvement in operations, so long as the taxpayer participates, e.g., in the making of management decisions or arranging for others to provide services (such as repairs), in a significant and bona fide sense. Management decisions that are relevant in this context include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions. Thus, the active participation standard is a lower standard than the material participation standard. Unlike the material participation requirements, there are no specific hourly requirements. It is possible that the taxpayer can meet the active participation standard for a rental property even when there is an on-site manager or a real estate agent handling the property. However, the taxpayer must be exercising his independent judgment and not simply ratifying the decisions made by the manager (*Madler v. Comm'r*, T.C. Memo. 1998-112).