

*From the desk of Jeanne M. Kerkstra, Esq., CPA*

**Viewpoint**

**IRS' Definition of "Business" - Is it Yours?**

The IRS has made it known that one of their focuses is now on the misclassification by taxpayers of hobbies as *bonafide* business activities carried on for profit.

A good case in point is *Keating v. Commissioner of Internal Revenue*.<sup>1</sup> In *Keating*, the taxpayer was an emergency room physician who worked for a local hospital in a small town in North Dakota. She had purchased a home on a 10-acre farm. Her husband was a firefighter-medic, and they had six children.

The taxpayer was under the impression that she was engaged in a business activity for profit when she bred, trained and showcased horses. Over a six year period she purchased about 20 horses. She consulted with veterinarians and other related specialists concerning breeding and caring for horses. She also discussed with her CPA how to keep books and records for this activity.

Her gross income from her emergency room work was about \$250,000. This was offset by significant losses from her horse breeding/training activity. Unfortunately, she got audited.

Several major factors were pivotal in the adverse finding against the taxpayer. First, the taxpayer commingled personal and business bank accounts. This is a glaring mistake.

Second, she and her family rode the horses for recreational purposes as well. I have found that when the IRS is looking for reasons to find against the taxpayer, it will cite to partial *personal* use for a reason to *strike down* the *entire* activity. This should be avoided at all cost.

Third, the court found lack of advertising persuasive against the taxpayer.

Fourth, there was not adequate accounting of the business activity. The court felt that the taxpayer should have had complete separate books and records for each horse including not only veterinary shots but also cost and revenue related to each. The taxpayer did not have this.

Fifth, although the taxpayer sought advice from a horse training specialist and a CPA, the court put a lot of emphasis on how the taxpayer did not seek advice on the business aspects of the operations. The court was looking for a business plan. It was also looking for financial projections as to when the activity might be anticipated to turn a profit. The court stated that it felt that horse breeding had a start-up period of between 5-10 years, and it was not unusual for start-up companies to have losses. The court expected the taxpayer to have gone to business advisors if she indeed had established a business activity for profit.

Reg. Sec. 1.183-2(b) lists nine relevant factors in determining whether an activity is engaged for profit. This is not an exhaustive list. Furthermore, simply achieving a majority of the factors will not get you a stamp of approval from the IRS.

**The bottom line is that if you truly want to have a strong case for establishing a business activity for profit, talk to all of your advisors, including your legal team. Call me today to set up an appointment. You only have money to lose if you don't.**

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