

## THE HOBBY LOSS RULE

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**T**he government does not consider every writer to be “in the business” of writing. If you do not report an annual profit (that is, income exceeding expenses) from your writing on a reasonably regular basis, the IRS might disallow some of your Schedule C business deductions by issuing a “hobby loss” challenge. The hobby loss rule, embodied in Section 183(D) of the tax code, prohibits taxpayers from fully deducting their business losses if the IRS finds their related activity is in pursuit of a hobby and not for profit. If the IRS concludes that you are writing as a hobby as opposed to for profit, then your deductions for related business expenses are limited to the amount of income you earned that year from your writing; you may not report a loss. By contrast, a writer deemed to be actively engaged in the business or trade of writing—that is, one who clearly pursues writing with a profit motive—may deduct all her ordinary and necessary business expenses, even if they exceed her income earned from writing in a given tax year.

The explanations and examples in this chapter are intended to illustrate how you can give yourself the best chance of prevailing in a hobby loss challenge. Organized and current record-keeping that shows you are engaged in seeking a profit from your writing is the key to succeeding. Before deciding to file Schedule C showing writing income and expenses,

discuss what is needed to show you are writing with a profit motive with your accountant or a tax lawyer, and if you receive an audit notice, get your advisor involved immediately.

The tests employed by the IRS to determine whether a taxpayer with self-employment income is in business or is engaged in a hobby are relatively straightforward. You do not need to make a profit from writing year after year, but you do need to show that you are actively working to earn a profit from your writing. The IRS provides a thorough explanation of Code Section 183, which it calls “Activities not engaged in for profit,” at its website.<sup>134</sup>

#### THE THRESHOLD TEST: PROFIT IN THREE YEARS OUT OF FIVE

The IRS employs a threshold test, which, if you pass, could end a hobby loss challenge. If a writer earns a net profit (i.e., income exceeding expenses) from her writing activity in any three of the previous five consecutive tax years, she is presumed to be in business. The IRS can overcome this presumption, but the burden of proof rests on it. Even if a writer does not meet this test, the IRS cannot disallow her business losses on that basis alone. Many writers who have experienced both good and bad years financially (as most writers have) are readily able to demonstrate a profit motive despite some years with losses.

The threshold test does not mean you are safe from a challenge until you have been reporting writing activity for five years. The IRS may audit individuals' tax returns for only three years after filing, so it cannot and does not have to wait for your business to exist for five consecutive years before it can challenge your loss in any given year. If you have not yet engaged in writing for profit for five consecutive years, you may file Form 5213 and elect to defer the IRS's determination as to your profit motive until after five consecutive years have passed. The risk of doing so is that if you are at that time determined to be writing as a hobby, you could owe back taxes, interest, and penalties for all five years. To bolster your defenses against a hobby loss challenge, if you use the cash method of accounting, and if it is reasonable and fair, try to defer the year end

<sup>134</sup> <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/IRC-%C2%A7-183:--Activities-Not-Engaged-in-For-Profit-%28ATG%29>

receipt of writing income and accelerate the payment of expenses to show that you have profited in some years. You might be better off reporting three years of profit and two years of larger losses than five straight years of small losses.<sup>135</sup>

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#### PROFIT MOTIVE: NINE FACTORS

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If you do not pass the threshold test of earning a profit in three years out of the past five, (or if you pass but the IRS seeks to rebut the presumption) you can still win a hobby loss challenge if you show a genuine profit motive. The tax code employs an objective standard based on all the facts and circumstances surrounding an activity. The code lists nine factors used to determine profit motive. Like many legal tests calling for consideration of several factors, the weight of each will vary depending on the unique case, and no single factor will necessarily trump the others. This is good news, because you can control to a significant degree whether you can demonstrate a pursuit of profit from your writing in a businesslike manner. Here are the nine factors used:

1. *The manner in which the taxpayer carries on the activity.* To satisfy this requirement, demonstrate that you have maintained effective business routines since you began reporting writing income on Schedule C. Thus, you should be able to present an organized and accurate bookkeeping system in which you have recorded all relevant receipts and expenses. A programmed system for engaging in regular relevant correspondence, submissions, follow-ups, contracts, deadlines, even rejection slips, will also be significant in showing your profit motive. However, the IRS disfavors a taxpayer's continued use of the same business practices that lead to continuous annual losses. Try to show that you have worked to identify and change what has contributed to your losses and to make your writing profitable. This might include tailoring your work to existing markets genres or exploring new markets. A word of caution here: if you make too drastic a change, the IRS could see the new method as a new and distinct business, and weigh this factor against you.

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<sup>135</sup> Be cautious about using this technique. The IRS frowns on unreasonable manipulation of the timing of the receipt of income and payment of expenses.

2. *The writer's expertise, or that of her advisors.* Significant indications of expertise include your educational background, publication credits, encouragement by agents or publishers, awards, prizes, membership in professional organizations, recognition in critical publications, and the retention of business advisors such as lawyers and accountants who are known to advise writers on a regular basis—so long as you follow their advice. Teaching and speaking engagements, if at least partially based on your writing expertise, can also help.
3. *The time and effort expended on writing and marketing your writing.* Can you show that you devote several hours daily on a regular basis to your writing and to selling your work? As most working writers well know, employment in another occupation hardly shows that you lack a writing profit motive, but if you earn a significant amount of overtime income from another job, for example, the IRS might conclude that you do not have enough time to devote to a separate writing business.
4. *The expectation that assets used in the activity will appreciate in value.* This factor is less relevant to writers than to other professions that make large capital or investment expenditures. The IRS does not consider your own copyrights to be capital assets.
5. *Past business success from other activity, similar or not.* Past literary successes, whether financial or critical, can show a present profit motive even if you have been inactive in publishing recently. Although somewhat counterintuitive, the IRS also favors past business success even if unrelated to writing, as long as you can show that it was regularly profitable.
6. *Your history of income or loss in the writing activity.* Use this factor to your benefit by showing your writing generated profits in most years, even if it also incurred losses in other years. This is less likely to help if you incurred significant losses in most years, interspersed with smaller profits in fewer years. But the IRS expects a start-up business to incur substantial losses in its early years. If you can show a significant reduction in your losses over the first several years, this can weigh in your favor.

7. *The amount of occasional profits, if any, earned from your writing.* Just as the IRS is realistic about early losses, it might consider receipt of a large advance or significant writing fees in one or intermittent years to offset the negative implication of losses in other years.
8. *Your financial status/dependence on writing income for your livelihood.* If you do not have substantial income or capital from sources other than your writing, it is more likely your activity has a profit motive. Substantial income from sources other than your writing, especially if your reported losses against your writing income earn you substantial tax benefits, might show you do not have the requisite profit motive.
9. *Elements of personal pleasure or recreation you derive from your writing.* If you are being audited, you will not help yourself by telling the examiner that you are writing for love and not money. The IRS wants evidence that you are working to earn a profit. You do not have to prove that the work is a bore and you are only writing to earn a living, but you should indicate that, even if you enjoy your work, you are still conducting it as a business, marketing yourself and your work, negotiating the best possible contracts, and the like.

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#### THE BOTTOM LINE

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The IRS does not want to give professional writers a hard time. The hobby loss rule is in place to prevent nonprofessionals from taking deductions to which they are not entitled. Writers who devote much of their time to their writing and to selling their work, who have demonstrable expertise, who have received recognition for their writing, or for whom the expenses of writing are financially burdensome are more likely to be found to be engaged in business rather than a hobby. This holds true even more for newer authors who demonstrate that they have made financial sacrifices to begin a writing career. Younger authors are often found to have a profit motive even if they need other employment to survive during the early years of their writing careers. Keep good records, seek advice from your tax advisor and follow it, and if you are acting as a professional, you should be able to overcome a hobby loss challenge.

## ILLUSTRATIVE CASES

The IRS is not the last word on a hobby loss ruling (or other tax determinations). A taxpayer who disagrees with an IRS determination can challenge it in court. A look at some typical hobby loss cases will illustrate the approach of the courts to the nine factors. Although these cases are not recent, they employ analyses that still apply.

*CASE I: THE DILETTANTE—NO PROFIT MOTIVE*

John Baltis graduated from college in 1948 and commenced work in the newspaper field. In 1967 and 1968, he was a copyeditor for the *San Francisco Chronicle*. During the same two years, he took deductions as a freelance writer—\$1,968 in 1967 and \$1,974 in 1968. Between 1948 and 1968, he had sold only three articles for a total of \$550. Many of his claimed expenses involved family visits. The result: No profit motive could be shown. Significantly, the tax court also pointed out “there was almost a complete failure to substantiate the specific items which the Commissioner disallowed.” Do not forget to keep accurate records to substantiate deductions.

*CASE II: THE WEALTHY SCHOLAR—NO PROFIT MOTIVE*

Corliss Lamont, a philosopher who taught at Columbia University, lectured across the country on philosophy, civil liberties, and international affairs. He also wrote numerous books and pamphlets about these subjects. He had independent wealth, so he could afford the continuous losses from his writing over a thirty-year period. The court concluded, “Although continuity and efficiency of operations are criteria which would tend to support the existence of a trade or business . . . the totality of circumstances surrounding Lamont’s background, his interest in the wide dissemination of his ideas, his activities and financial status justifies the conclusion of the Tax Court that a profit motive was lacking.”

*CASE III: THE ESTABLISHED AUTHOR TRAVELING FOR RESEARCH—PROFIT MOTIVE*

Stern, a writer of numerous articles and screenplays and a resident of Los Angeles, spent 335 days in New York City during 1965. He had been writing for almost forty years. The author was an expert on the film director D.W. Griffith and spent the time in New York researching Griffith’s papers

at the Museum of Modern Art. The results of his work provided the basis for an issue of *Film Culture Magazine* published in 1965, and the contents of the magazine were then to be used in a hardcover book scheduled for future publication. Stern received no income from the magazine, but had a contract providing for standard author's royalties on the hardcover book.

The court found a profit motive because the author had "participated in that endeavor with a good faith expectation of making a profit," despite the lack of immediate profits.

#### CASE IV: A WRITING VANDERBILT—PROFIT MOTIVE

Cornelius Vanderbilt, Jr. commenced his writing career in 1919 and pursued it with great success for two decades, despite his wealthy family cutting off his allowance. He published numerous books and articles in addition to founding newspapers and a news service syndicate. Motion picture producers purchased a number of his stories, and he began a successful lecture career in 1929. World War II and health problems curtailed his writing. He resumed his writing and lecturing career after the war and often wrote about travel and current foreign affairs. Much of Mr. Vanderbilt's writing, including several books, was devoted to these topics.

His writing-related activities, especially a substantial amount of travel, caused his deductions to far exceed his writing income. The IRS sought to disallow the entire amount of business deductions claimed in 1951—\$30,175.90—on the rationale that Mr. Vanderbilt was not in the business or trade of being a writer in that year. It argued that his large losses over several years, inherited wealth, inattention to practical business details and even "his general propensity towards engaging in this field of endeavor whether it resulted in profit or not . . ." showed no profit motive.

The court disagreed with the IRS's characterization of Vanderbilt's career as bearing "a strong resemblance to that of a romanticist and adventurer." His past commercial success and continued devotion to his writing demonstrated his profit motive more than adequately.

