

Establishing a Profit Motive When Starting a New Business Venture

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Are you interested in turning one of your passions into a business venture?

Do you wonder if you can deduct your travel costs because you are writing a book?

Before you start claiming deductions for the costs of your art projects or classic car collection, you want to make sure your venture will qualify as a business for tax purposes. You're not allowed to deduct the expenses related to your favorite *personal* activities – only the expenses of a legitimate, profit-motivated business. Therefore, if you consistently use your business as a tax shelter, deducting losses year after year, you risk catching the attention of the IRS. If you're audited, you'll have to prove your profit motive.



In determining whether an activity is being operated with an "actual and honest" profit motive, the IRS typically applies nine relevant factors. These factors are not necessarily all-inclusive and no single factor controls the assessment of profit motive. Additionally, the fact that there may be more factors "in favor" of one conclusion versus the other is not determinative. More weight is given to objective facts than to statements of intent made by taxpayers, based primarily on the following nine factors:

(1) The manner in which you carry on the activity -

Carrying on an activity in a businesslike manner, with complete and accurate books and records and a formal business plan, can be indicators a profit motive. Any plan you put together should demonstrate your legitimate financial and economic forecast for the activity and should not simply be a "fantasy profit and loss statement." A profit motive may also be indicated where you carry on an activity in a manner substantially similar to other activities of the same nature which are profitable. Be aware, though, that the presence of sophisticated books, records and plans does not automatically equate to profit motive. In order to support profit motive, you should rely upon the books and records to operate the activity and make business decisions or changes. Changing operating methods, adopting new techniques or abandoning unprofitable methods in a manner consistent with an intent to improve profitability are all signs that you are serious about operating a for-profit activity.

(2) Your expertise and that of your advisors -

Preparing to launch your new activity by extensively studying accepted business, economic, and scientific practices, or consulting with people who are experts therein, may be indicators of a true profit motive. This assumes that you carry on the activity in accordance with such practices and expert advice. When you prepare in such a manner or procure expert advice, but don't operate the activity consistent with that research or advice, you risk revealing a lack of intent to derive a profit unless you can show that you are attempting to develop new or superior techniques which may ultimately result in profits.

(3) The time and effort expended in carrying on the activity -

The fact that you devote much of your personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate your intent to derive a profit. Withdrawing from another occupation to devote most of your energies to the activity would clearly be evidence of profit motive. However, devoting a limited amount of time to an activity does not necessarily indicate a *lack* of profit motive on your part. This is especially true where you employ competent and qualified people to carry on the activity for you. Your time and effort reading magazines, journals, and other periodicals are unfortunately treated as consistent with engaging in a hobby versus a for-profit activity.

(4) Expectation that assets used in activity may appreciate in value -

The term “profit” encompasses appreciation in the value of assets, such as land or collectibles, used in an activity. Thus, while you may intend to derive a profit from the operations of an activity, you may also intend that, even if no profit from current operations is derived, an overall profit will result when the appreciation in the value of property used in the activity is realized. This assumes that the income from the activity together with the appreciation of the property will exceed the expenses of operation. Various courts have differed in their application of this factor, with some including unrealized appreciation in boats, limousines, equipment and real property in determining whether a taxpayer had a bona fide profit motive.



The appreciation of property may only be used as a consideration for profitably intent if the operation of the activity and the holding of the assets are considered to be a single activity. If the operation of the activity and the holding of the assets are considered to be separate activities, then the appreciation of the assets will not be considered for overall profit.

The application of this factor relies upon potential future asset gain to offset current deductions/losses. One consideration is whether you intend to retire on the site (assuming the property in question is land). Frequently taxpayers have purchased properties for the purpose of future retirement and, if that is the case, then no future gain will be realized related to the activity and no appreciation in value may be considered for determining a profit motive.

(5) Your success in carrying on other similar or dissimilar activities -

If you have engaged in similar activities in the past and converted them from unprofitable to profitable enterprises, it may be a significant indicator that you are engaged in the present activity for profit even though the activity may presently be unprofitable. The application of this factor will focus on activities in addition to the your primary source of income. For example, if you are a medical doctor, the success of your medical practice would not be considered in determining your profit motive for a tree farm.

(6) Your history of income or losses with respect to the activity -

This factor is one of the most important factors as it supports the framework of Internal Revenue Code section 183 (often referred to as the *Hobby Loss Rules* because many individuals have engaged in unprofitable activities due to the pleasurable attributes of the activities). A series of losses during the initial or start-up stage of an activity may not necessarily be an indication of a lack of profit motive. However, continued losses, beyond the period in which an activity may ordinarily become profitable, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen circumstances which are beyond your control (such as drought, disease, fire, theft, weather damages, depressed market conditions, etc.), such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized is the strongest evidence that you are operating a for-profit activity.

(7) The amount of occasional profits earned -

The amount of profits in relation to the amount of losses incurred, and in relation to the amount of your investment and the value of the assets used in the activity, may provide useful criteria in determining your profit intent. An occasional small profit from an activity generating large losses, or from an activity in which you have made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, even if only occasional, would be indicative that an activity is engaged in for profit, especially where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

(8) Your financial status -

Individuals who do not have substantial income or capital from sources other than the activity are more likely to be looked upon as engaging in a for-profit activity. Conversely, having substantial income from sources other than the activity (particularly if the losses from the activity generate significant tax benefits) may indicate that the activity is not engaged in for profit, especially if there are personal or recreational elements involved. A failure to abandon an unprofitable activity, when other taxpayers who lack the same financial wherewithal would most likely do so, would likely be viewed as consistent with a lack of profit motive.

The Tax Court has pursued many cases involving taxpayers who (1) have other substantial sources of income and (2) have engaged in historically unprofitable activities without abandonment. In general, these individuals have not fared as well in Tax Court litigation as taxpayers who do not have such financial wherewithal.



(9) Elements of personal pleasure or recreation -

The presence of personal motives in carrying on an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks substantial appeal other than profit. Keep in mind, however, that it is not necessary that you engage in an activity with the *exclusive* intention of deriving a profit or to maximize profits.

The type of personal pleasure that may defeat a profit motive refers to enjoyment of non-business aspects of the activity, such as travel to vacation locales unrelated to the business operation. In other words, the presence of substantial recreational elements would be a negative factor, whereas the complete absence of recreational elements weighs in favor of a true profit motive.

The Final Word

The determination of profit motive for a business is rarely and open and shut case. The nine-factor text provides guidance and IRS regulations attempt to address the gray area between the two extremes of “definitely a business” and “definitely not a business” with the following:

- (1) The availability of other investments that would yield a higher return than the activity, or that would be more likely to be profitable, is not evidence that an activity is not engaged in for profit;*
- (2) an activity is not treated as lacking a profit motive merely because the taxpayer has purposes or motivations other than solely to make a profit;*
- (3) the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to defeat a finding of a profit motive if the activity is in fact engaged in for profit as evidenced by other relevant factors.*

What Should You Do?

If you are considering starting a new business venture, please contact us to discuss your specific circumstances. A true profit motive intent is just one of the many considerations to take into account when planning the start-up of a new business. There are many other issues that can significantly impact your tax situation.

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