Hobby Loss Questionnaire

You should be prepared to defend the assertion that your Schedule C activity was engaged in for profit, instead of as a hobby. In determining which is the case, the questions the IRS might ask are as follows:

1. Did you begin your business and continue in your business with the objective of making a profit?
2. Is there even a small chance that you will make a large profit?
3. Did you make a concerted effort to maintain complete and accurate books and records?
4. Did you ever adopt new selling and/or recruiting techniques, or did you abandon unprofitable selling and/or recruiting methods with an intent to improve profitability?
5. Did you already possess expertise in product knowledge, sales, or recruiting that would have prepared you for your business? If not, did you endeavor to learn from those who are experts in any of these areas?
6. Did you devote much of your personal (non job-related) time to your business? Was there ever a time when you went from part-time to full-time in your business? Did you ever quit a full-time job so as to devote more time to your business?
7. Do you expect to sell the cosmetics (or other product) for more than you pay for them?
8. Do you have any prior success in carrying on a business of your own?
9. Has your business ever shown a profit? Please note: Many home-based businesses report a net loss where there would otherwise be a profit. This is so because of three major benefits for the home-based self-employed business owner: 1) the deduction allowed for the standard mileage rate on a business vehicle is often greater than the actual out of pocket cash expenses incurred to operate the vehicle, thus giving the business owner the opportunity to deduct more than what they spend; 2) a deduction for operating a business from home for which the business owner incurs little to no additional expense to maintain; and 3) a depreciation deduction on assets converted to business usage for which the business owner has no new capital outlay.
10. Do you have any reason to believe that you have an opportunity to earn a substantial ultimate profit? What proof do you have to show this opportunity exists? Are there any other people within the sales force who have earned a substantial ultimate profit?
11. Do you have any other sources of income or means of support?
12. How much of the reason you got into the business was because it was fun and how much of it was because you wanted to make money?

A typical reply to the IRS contesting their ruling that your business is a hobby and is not engaged in for profit could look something like the following:

Dear (IRS auditor),

I wish to contest your ruling that I engage in my business as a hobby and not with the motivation of making a profit. To do so I am employing the tests from Section 183 of the Internal Revenue Code to determine if my business was engaged in for profit during the period in question.

I began my business and continued in it during this period with the objective of making a profit. Although I enjoy working my business, the reason I started this business was because I wanted to make money. There has always been at least a small chance that I would make a large profit. For one, I expected the price of the cosmetics (or other product) to appreciate in value by being able to sell them for more than I paid for them, thus generating a profit to me.

I made a concerted effort to maintain complete and accurate books and records. (Give examples of the types of records you kept during this period.)

I adopted new selling and/or recruiting techniques, and abandoned unprofitable selling and/or recruiting methods with the intent to improve profitability. (Give examples.)

[If applicable, “I already possessed expertise in (your business’ product or service), sales, or recruiting that prepared me for my business. (Explain) Furthermore, I endeavored to learn from those who are experts in these areas by attending numerous selling, recruiting, and (your businesses product or service) training classes, workshops, and seminars.” If not applicable, “Although I did not already possess expertise in (your business’ product or service), sales, or recruiting that would have prepared me for my business, I endeavored to learn from those who are experts in these areas by attending numerous selling, recruiting, and (your businesses product or service) training classes, workshops, and seminars.”] [If applicable, “Moreover, I have prior success in carrying on a business of my own. (Explain)”]

I devoted much of my personal (non job-related) time to my business. [There was a time from (date?) to (date?) when I went from part-time to full-time in my business.] (I even went so far as to quit my full-time job so that I could devote more time to my business.) (If applicable, “Also, I did not have any other sources of income or means of support.”) Therefore, I was highly motivated to make my business earn a profit.

 (If your business has shown a profit, name the years it has shown a profit.) (If your business has NOT shown a profit, then you might wish to write, “Although my business has yet to show a profit, please note that many home-based businesses report a net loss where there would otherwise be a profit. This is so because of three major benefits for the home-based self-employed business owner: 1) the deduction allowed for the standard mileage rate on a business vehicle is often greater than the actual out of pocket cash expenses incurred to operate the vehicle, thus giving the business owner the opportunity to deduct more than what they spend; 2) a deduction for operating a business from home for which the business owner incurs little to no additional expense to maintain, yet gets to claim the business portion of the deduction as if it was an additional expense; and 3) a depreciation deduction on assets converted to business usage for which the business owner has no new capital outlay.”)

I have every reason to believe that I have an opportunity to earn a substantial ultimate profit. There are thousands of people within the sales force who have earned a substantial ultimate profit. (Give some dollar examples.) This has always given me hope that if I work this business hard and long enough I, too, could earn at least a fraction of that kind of income.