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**CHAPTER 1**

# What Is a Business for Tax Purposes?

**The chief business of  
the American people  
is business.**

—Calvin Coolidge

The Internal Revenue Code requires that you be engaged in a trade or business in order to claim trade or business deductions on Schedules C, C-EZ, F, or E of Form 1040, or employee business deductions on Schedule A of Form 1040. Deductions for the use of a home office are a special kind of trade or business deduction. In this chapter, you will learn how to structure an activity so that it qualifies as a trade or business, and how to identify legitimate trade or business deductions.

Although the term *trade or business* is used hundreds of times in the Code and IRS regulations, neither Congress nor the IRS has provided us with a general definition. Over the years, the IRS and taxpayers have had differences of opinion about what this term means, and occasionally the dispute has wound up in the Supreme Court.

In a recent decision, the Supreme Court said:

We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity, and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify. [Commissioner v. Groetzinger, 480 U.S. 23.35 (1987)]

So generally, if you are engaged in an activity on a regular and continuous basis, and your main purpose is to earn an income, you have a trade or business. (Exceptions to this rule are discussed next.) Your business need not be full-time, and you could be engaged in several businesses at once. Being engaged in

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a trade or business does not presume that you are actually earning an income, or generating any revenue at all—only that you are trying. However, your main purpose for engaging in the activity must be to earn a profit, and the best way to indicate this is to actually show a profit at some point.

### Investing Cannot Be a Business

An exception to the previous definition of trade or business is the activity of investing in securities or collectibles to generate long-term profits. In 1941, the Supreme Court held that the activity of investing is not a trade or business. Consequently, as an investor, you may not deduct the costs of an office at home regardless of what you are investing in, whether it is stocks and bonds or rare beer cans.

This is not to say that investment related expenses are not deductible; only that home-office deductions cannot be claimed as investment expenses. Section 212 of the Code allows investment-related expenses to be deducted by individuals. These are generally included on Schedule A (line 22) as miscellaneous itemized deductions. Gains and losses from the investments are generally capital gains and losses and are reported on Schedule D (“Capital Gains and Losses”).

If you are a *trader* or a *dealer* in securities or commodities, your activities probably qualify as a business, and you can report your income and deductions on Schedule C. Now the question is: How do you tell whether you are an investor, a trader, or a dealer?

### Dealing or Trading Could Be a Business

If you buy and sell regularly on an exchange (for securities) or any other active market (commodities, for example), you might be either a dealer or a trader. If you buy with the expectation of reselling at a profit not because of a rise in value between the purchase and resale, but merely because you have a market of buyers who will purchase from you at a price in excess of your cost, you are a dealer. The markup between your purchase price and your selling price represents compensation for your service in bringing buyers and sellers together.

Traders, on the other hand, do not perform a merchandising function, because their source of supply is not significantly different from that of those to whom they sell. That is, they trade in an open market and perform no services that need to be compensated for by a markup in price. If you are a trader, you depend on such circumstances as a rise in value or an advantageous purchase to be able to sell at a price in excess of your cost. As a trader, you seek profit

from short-term market swings and receive income principally from the activity of buying and selling rather than from dividends, interest, or long-term appreciation.

The primary distinction, for tax purposes, between a trader and a dealer is that a dealer reports gains and losses as ordinary business gains and losses on Schedule C, while a trader generally reports gains and losses as capital gains and losses on Schedule D. Nevertheless, if you are either a dealer or a trader, you will be deemed to be engaged in a trade or business if your trading is frequent and substantial. This also means that if you deal or trade out of your home, your home-office expenses are deductible.

The difference between an investor and a trader relates to your motive for buying and selling. While a trader seeks profit from short-term market swings rather than from dividends, interest, or long-term appreciation, an investor makes purchases for capital appreciation and income, usually without regard to short-term developments. If you are actively buying and selling securities or other property as a dealer or trader, it doesn't mean that you cannot also be an investor with respect to some of your transactions, but those transactions should not be considered part of your business.

The distinction between being a trader (having a business) and being an investor (not having a business) is a pretty fuzzy one. It is a factual question that depends on your own situation and personal motivation. You bear the burden of proving that your activities constitute a trade or business. See *Paoli v. Commissioner*, T.C. Memo. 1991-351. Therefore, if you decide that you're a trader, you should be prepared to back up your conclusion if questioned by an IRS agent.

## **Rents from Real Estate**

If you are a dealer or trader in real estate, and you receive rents from property you are holding for resale, the rental income and deductions are reported on Schedule C (Form 1040) along with your other business income and deductions. If you run a hotel, a boarding house, or an apartment house where you provide hotel services to the occupants, or if you provide space in parking lots, warehouses, or storage garages, the income and deductions are also reported on Schedule C.

In contrast, if you do not provide services to tenants and you are neither a dealer nor a trader, your income and deductions from rental real estate are reported on Schedule E, Part I ("Income or Loss from Rental Real Estate and Royalties"). Even if your real estate rental activities take a lot of time, and even if you rent appliances and furniture with your buildings, you still use Schedule E as long as you do not provide services to the renters.

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Because income reported on Schedule E is generally considered investment income, you don't pay self-employment tax (social security tax) on Schedule E net income. However, depending on your degree of involvement, rental activities reported on Schedule E can be considered a business rather than an investment activity. The courts have held that renting even a single property can constitute a business for various purposes. In the 1980 case of *Curphey v. Commissioner*, 73 T.C. 766 (1980), the Tax Court held that the rental activities of a dermatologist who was employed full time by a hospital, but who also owned and managed six rental properties, constituted a business for the purpose of claiming home-office deductions. The Tax Court made it clear that ownership and management of such properties will not always qualify as a business, and that the scope of a taxpayer's management activities will be the deciding factor.

In spite of the *Curphey* decision, the unofficial position of the IRS is that home-office deductions are not available in connection with rental real estate. Therefore, even if you satisfy the Tax Court's trade or business requirement, and all the other requirements under Section 280A, you still might have to butt heads with an IRS agent over home-office deductions on Schedule E.

### Is It a Hobby or a Business?

A rule laid down by the Supreme Court is that a business cannot be merely a hobby. Having a hobby means that your primary objective in engaging in the activity is to have a little fun rather than to be profitable. So the deciding factor in distinguishing a business from a hobby is whether the activity is engaged in for profit.

#### ***Relevant Factors in Determining a Profit Motive***

The IRS has specified nine factors in the regulations that it will use to determine a profit motive. It stipulates, however, that whether a profit motive exists depends on the circumstances of each case, and all relevant information beyond the factors specified will be taken into account. The IRS has cautioned that it places greater weight on objective facts than the taxpayer's mere statement of subjective intent. Nine factors listed in the regulations include:

1. *The manner in which the taxpayer carries on the activity.* If you take your business seriously by operating in a businesslike manner and maintaining a complete and accurate set of books, you would appear to have a profit motive. Additionally, carrying on your business in substantially the same way as others in the same business who are profitable would indicate a profit motive. You would also demonstrate a profit motive if you change your operating procedures, adopt new techniques, or abandon old methods in an effort to improve your profitability.

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Here are a few things you can do to help satisfy this requirement. Get an Employer Identification Number (see Chapter 8) and apply to the Secretary of State (for your state of business) for an assumed business name. Become aware of all the state and local requirements for home-based businesses and comply with them. Have a separate checking account for your business and use it only for business transactions. Most importantly, set up a formal bookkeeping system, even if it is a simple single-entry system (see Chapter 9).

2. *The expertise of the taxpayer or his advisors.* Preparation before commencing the business activity through extensive study of its accepted business, economic, and scientific practices, or consultation with experts, may indicate a profit motive if you carry on the activity in accordance with such practices. On the other hand, if you consult with experts and don't do what they say, it might indicate a lack of profit motive, unless it appears you are attempting to develop superior techniques.

For example, if you think it would be a good idea to raise Giant African Bullfrogs so you can sell their big juicy legs to restaurants, don't just run out and start buying frogs. Come up with a business plan detailing how you will become profitable in the frog business. Do some reading about the frogs first. Learn how to care and feed the frogs. Learn what kind of environment the frogs are comfortable in and come up with an adequate facility. Talk to Giant African Bullfrog experts, if you can find any. Most importantly, see if their legs are tasty and find out if anyone else likes them. To claim business deductions you must be able to demonstrate to the IRS that you thoroughly researched the business that you are in and have adequate knowledge of the business to make it profitable.

3. *The time and effort expended by the taxpayer in the activity.* The fact that you devote much of your personal time and effort to the activity, particularly if the activity is not a lot of fun, may indicate a profit motive. Quitting your day job to devote more time to your business is another indication of a profit motive. However, the fact that your business is part-time and you only have limited time to devote to it does not necessarily indicate lack of profit motive.
4. *Expectation that the assets used in the activity will appreciate in value.* The term *profit* includes appreciation of your business assets. So even if you have losses from current operations, your expectation that your business property will appreciate over time to produce an overall profit, will demonstrate a profit motive.
5. *The success of the taxpayer in carrying on other activities.* Entrepreneurial success in the past with other business ventures might indicate a

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profit motive in your current activity, even if the activity is currently unprofitable.

6. *The taxpayer's history of income or losses with respect to the activity.* If losses are sustained after the time that is usually necessary to make the operation profitable, such losses might be an indication of lack of profit motive. However, if such losses result from circumstances that are beyond your control, such as natural disasters, fire, theft, disease, or depressed market conditions, such losses would not be indicative of lack of profit motive.

Remember that a reasonable expectation of profit is not required. For example, suppose you think you're going to make a killing in a wildcat oil well operation that produces large losses year after year, even if everyone thinks you're crazy and should get out of the investment while you still have your shirt. Regardless of how speculative the investment, the oil well activity would be considered engaged in for profit.

7. *The amount of occasional profits, if any.* Generating an occasional small profit is not necessarily indicative of a profit motive, especially if your investment is large or you have sustained large losses in other years. However, a large profit, though only occasional, would indicate a profit motive when the investment or losses in other years are comparatively small. Also, the opportunity to eventually earn substantial profit in a highly speculative venture is usually sufficient to indicate a profit motive.
8. *The financial status of the taxpayer.* The fact that you do not have substantial income or capital from sources other than the activity might indicate that the activity is engaged in for profit. In other words, if you are going to have to generate income from your activity in order to eat, that's a pretty good indication that you expect to make a profit. On the other hand, if you or your spouse has a well-paying job, or if you have a lot of money stashed away, it might be an indication you do not have a profit motive. This is especially true if you are claiming large losses and the business you are engaged in is fun.
9. *Elements of personal pleasure or recreation.* If your business activity involves doing what you love to do for recreation, that might indicate a lack of profit motive. In contrast, if your business activity is not any fun at all, that might indicate a profit motive. Nevertheless, personal enjoyment is not sufficient to tip the scales either way; you are not expected to be motivated strictly by profit and to do work that is not enjoyable.

For example, suppose you have enjoyed fishing as a hobby for years. If you become a professional fishing guide and incur start-up losses, the fact that you love to fish might be one indication that you are not engaged in

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the activity for profit. However, if you carry on in a businesslike manner, are knowledgeable in what you do, and have quit your other job to pursue your new business, you will demonstrate a profit motive.

***What to Do if All You Have Is a Hobby***

There is actually a section in the Internal Revenue Code that allows the deductibility of expenses incurred in connection with a hobby. This is a Code section that you want to utilize only if you lose the argument that your activity is a business. It only applies if the hobby is conducted by an individual, an S corporation, or a partnership. It is Section 183 and it allows you to deduct your hobby expenses to the extent that your hobby generates income. These expenses are only deductible as Miscellaneous Itemized Deductions on Schedule A, subject to the reduction by 2 percent of your Adjusted Gross Income. Any expenses in excess of income that are not otherwise deductible are lost forever.

**Identifying Deductible Business Expenses**

“Can I write this off?” That’s a question that has been asked of tax accountants countless times since the enactment of our income tax in 1913. It often relates to whether an amount qualifies as a deductible business expense. Sometimes the answer is not easy.

The first issue to consider is whether a taxpayer is conducting a business as opposed to an investment activity or a hobby. Some investment and hobby expenses are deductible, but they are subject to separate limitations and reporting requirements, as discussed earlier.

Some business expenses, like entertainment and travel expenses, are subject to special record-keeping requirements. Still others, like home-business deductions, are limited by special rules. These topics are addressed in later chapters. Before the limitations apply, however, a cornerstone section of the Code provides the basic foundation of deductibility. It is IRC Section 162. Here is the pertinent part:

Sec. 162. Trade or Business Expenses.

(a) In General—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . .

There is a lot more to Section 162 than shown here, but within this phrase are all the general criteria. Each item must meet the four conditions specified in this phrase to be deductible as a business expense. It must be (1) an *expense* as opposed to a capital expenditure, (2) *ordinary* and *necessary*, (3) *paid or incurred*, and (4) for *carrying on a trade or business*.

### ***Is It an Expense?***

An expense is a cost that primarily benefits the immediate taxable year, in contrast with a cost that will benefit your business for several years to come. For example, a car repair is an expense, while a new car is not—it is a capital expenditure. The monthly phone bill is an expense, while the cost of purchasing your phone is not. The cost of a business car or a business phone might be deductible as depreciation over the years they are used for business. These assets might even be deductible in full in the year of purchase under a special Code provision (Section 179). But they do not qualify as Section 162 deductions. See Chapters 5 and 7 for more detailed information.

### ***Is It Ordinary and Necessary?***

The meaning of ordinary and necessary has been left to the courts to interpret. These are terms that have never been defined by the Code or regulations. “Ordinary,” according to the Supreme Court, means “normal, usual, or customary.” The Court also said an expense may be ordinary even though it happens only once in a taxpayer’s lifetime. An example would be the cost of defending your business against a lawsuit.

“Necessary,” according to the Supreme Court, means no more than “appropriate and helpful” in running your business. For example, if you embark on a massive TV advertising campaign because you believe it will increase your net income, the IRS does not have the right to disallow the expense because the agent believes it to be a bad business decision. The courts have tended to accept the judgment of taxpayers regarding the business value of expenditures; they don’t want IRS agents acting as business efficiency experts.

Deductions have also been disallowed under the ordinary and necessary standard if they are incurred primarily for personal reasons rather than for a business purpose. There is a pretty fuzzy line between what the IRS and the courts consider primarily personal and what they consider to be an ordinary and necessary business expense.

### ***Is It Paid or Incurred During the Taxable Year?***

This requirement relates to the method of accounting you use for your business. If you are on the cash method, it is not good enough to have *incurred* an expense; you must pay it to deduct it. Likewise, if you are on an accrual method, you must have incurred an expense according to the rules for accrual method taxpayers to deduct it. See Chapter 3.

### ***Are You Carrying on a Trade or Business?***

An expense is not a deductible business expense unless you are *carrying on* your business at the time it is paid or incurred. To be carrying on means to be

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actually conducting business rather than preparing to conduct business. For example, let's say you are opening a travel agency in your home. The first month you decorate your office, install a phone line, set up your computer system, and send out promotional literature. It is not until the second month that you begin to accept clients. Any ordinary and necessary business expenses incurred during the first month are not incurred in *carrying on* a trade or business. That means you can't deduct them as business expenses. A separate provision in the Code (Section 195) allows you to amortize them over a 60-month period beginning with the month you begin business.

### **Additional Resources**

Additional information on business and investment expenses is found in Publication 535, *Business Expenses*; and Publication 550, *Investment Income and Expenses*. Publication 910, *Guide to Free Tax Services*, provides a list of free tax publications and an index of tax topics and related publications. It also describes other free tax information available from the IRS, including tax education and assistance programs.

You can get these publications free by calling the IRS at (800) TAX-FORM [(800) 829-3676]. If you have access to TTY/TDD equipment, you can call (800) 829-4059. To download them from the Internet, go to *www.irs.gov* (World Wide Web), or *ftp.irs.gov* (FTP). If you would like to get forms and instructions (not publications) by FAX, dial (703) 368-9694 to reach IRS Tax Fax.

