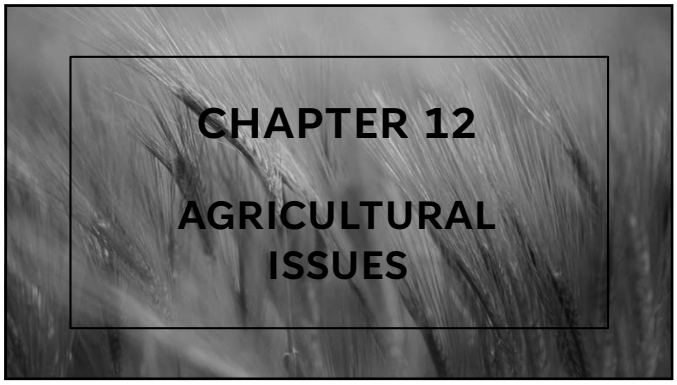

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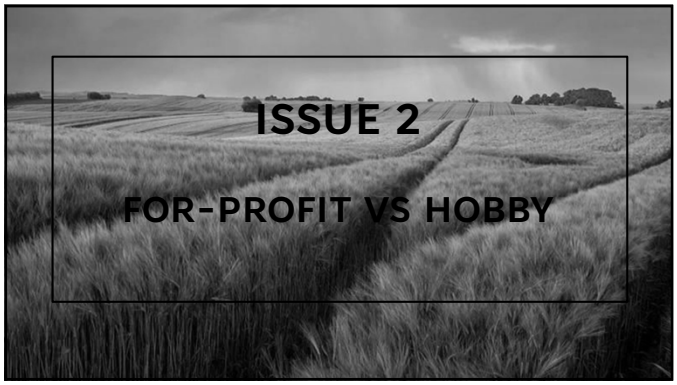

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PG 440

- Whether a taxpayer is engaged in a trade or business determines on the timing and allowance of deductions
- If the trade or business has **not yet started**, the expenses are **startup expenses**
- If the activity is without a **profit motive**, the activity is a hobby and deduction for expenses is limited.

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STARTING A TRADE OR BUSINESS PG 440

- Facts and circumstances of each case determine whether a taxpayer's activities are a trade or business.
- Activities must be regular and continuous
- Must be conducted for purpose of earning a profit
- A sporadic activity, hobby, or amusement does not qualify as a trade or business

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STARTING A TRADE OR BUSINESS PG 440

- Until the business starts to function as a going concern and performs the activities for which it was organized, it is not a trade or business
- Until the business has started, expenses incurred are **not** currently deductible under I.R.C. **§**162
- They are startup expenses, subject to I.R.C. **§**195 rules

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STARTING A TRADE OR BUSINESS PG 440

- Carrying on a trade or business is more than initial research or investigation as to business potential
- Business operations must have actually started
- Expenditures must satisfy the requirements of **§**162

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STARTING A TRADE OR BUSINESS PG 440

Courts have focused on 3 factors to determine whether a taxpayer is engaged in a trade or business

1. Whether the taxpayer intended to earn a profit
2. Whether the taxpayer is regularly & actively involved
3. Whether the activity has actually commenced

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STARTING A TRADE OR BUSINESS PG 440

- For expenses to be deductible under §162, principal objective is to earn a profit
- A planned business must reach a productive state before the taxpayer can deduct trade or business expenses

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Cross-Reference: Startup Expenses Pg 440

- In the year the business begins, **§ 195** allows up to **$5,000** of startup costs, **reduced** by the amount over **$50,000**, with the remainder deducted **ratably over 180 months** (15 yrs)
- *See* **pages 331-337** of the ***2025 National Income Tax Workbook***

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BUSINESS OPERATED FOR PROFIT PG 441

If business is operated predominantly for recreation or pleasure and not on a commercial basis, **not** a trade or business and **deduction** for expenses is **limited**

Taxpayer must be engaged in the activity with an **actual** and **honest profit** objective

Profit means economic profit, independent of tax savings

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PROFIT MOTIVE FACTORS

Taxpayer bears burden of proving activity is engaged in for profit

9 non-exclusive factors may be relevant

1. Manner the taxpayer carries on the activity
2. Expertise of taxpayer or advisers
3. Time & effort expended by the taxpayer

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PROFIT MOTIVE FACTORS

4. Expectation that the assets used in the activity may appreciate in value
5. Success of taxpayer in other activities, similar or dissimilar
6. History of income or losses with respect to activity

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PROFIT MOTIVE FACTORS

7. Amount of occasional profits earned, if any
8. Financial status of the taxpayer
9. Elements of personal pleasure or recreation involved

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PROFIT MOTIVE FACTORS PG 441

- Courts apply the 9 facts and circumstances to each case to determine whether activity engaged in to make a profit
- Courts may consider other facts and circumstances
- If taxpayer conducts more than one activity, the factors are applied separately to each activity

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MANNER IN WHICH THE TAXPAYER CARRIES ON THE ACTIVITY PG 442

To indicate a profit motive and operating in a businesslike manner, considerations include whether the taxpayer

1. Maintained complete and accurate books
2. Prepared a business plan
3. Conducted the activity in a manner similar to comparable activities that were profitable

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MANNER IN WHICH THE TAXPAYER CARRIES ON THE ACTIVITY PG 442

4. Changed operating procedures, adopted new techniques, or abandoned unprofitable methods with an intent to improve profitability
5. For horse breeding and sales, ran a consistent and concentrated advertising program

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EXAMPLE 12.4
NO BUSINESS PLAN OR SEPARATE ACCOUNT



Wesley & Janet Young operated Pecandaros Ranch.

Reported almost $3,000,000 in total losses

(Young vs Commissioner, T.C. Memo 2025-95)

- Used a personal bank account
- Did not track expenses
- In the year of audit, began using QuickBooks
- They formed an LLC
- Opened a business bank account

IRS determined books & records were deficient

Records did not establish existence of a business plan

Finding: Not a trade or business

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EXPERTISE OF THE TAXPAYER AND ADVISER PG 442

Other factors that may indicate a profit motive:

- Taxpayer's own expertise or research
- Extensive study of an activity
- Consultation with experts
- Whether the taxpayer followed the adviser's advice in conducting the activities

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TIME & EFFORT DEVOTED TO THE ACTIVITY PG 442

Expending **significant time and effort** by the taxpayer may indicate a profit objective

Devoting a **limited time** to the activity **does not** indicate lack of profit motive if taxpayer employs competent and qualified persons to carry on the activity

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EXPECTATION THAT THE ASSETS MAY APPRECIATE IN VALUE PG 443

Asset appreciation may indicate profit motive even without operational profit – but only where the appreciation **exceeds operating expenses** and would **recoup accumulated prior losses**

A **vague notion** of appreciation is not enough

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SUCCESS OF TAXPAYER IN OTHER OR SIMILAR ACTIVITIES PG 443

Turning **similar ventures profitable** may show the present (even if currently unprofitable) activity is for profit

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HISTORY OF INCOME OR LOSSES WITH RESPECT TO THE ACTIVITY PG 443

- A history of **income or losses** may indicate the presence or absence of profit motive
- **Startup-stage losses** don't necessarily mean a hobby, but losses beyond the customary startup period may
- The objective must be to profit on the **entire operation**, including enough net earnings to recoup the losses

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EXAMPLE 12.7 EXPECTATION OF FUTURE PROFIT PG 443

- Ken Kolar inherited the family ranch
- Required work to rebuild
- 5-6 years to reach profitability
- During this time, ranch operations were adversely affected by natural disasters



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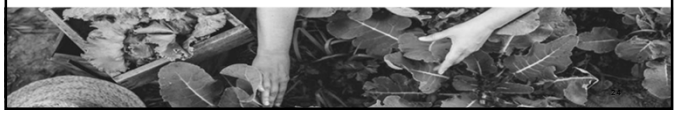
EXAMPLE 12.7 EXPECTATION OF FUTURE PROFIT PG 443

Ranch had **significant losses**

Ken had a **profit motive**

- Separate checking account
- Plan to increase herd
- Decades of experience in ranching and sales & marketing
- Majority of time spent trying to improve it



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EXAMPLE 12.7 EXPECTATION OF FUTURE PROFIT PG 443

Court finding:

- Losses attributable to reinvestment into a degraded ranch
- Length of time necessary to rebuild cattle herd
- Unforeseen casualty events

Ranching activity was for profit



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AMOUNT OF OCCASIONAL PROFITS EARNED PG 444

Intent - Amount of profits, in relation to losses

Profit objective - Taxpayer's belief in earning a substantial profit, if adequately supported

Expectation of gain and not gain itself is one factor that determines a profit motive

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AMOUNT OF OCCASIONAL PROFITS EARNED PG 444

- An occasional small profit from activity generating large losses, or taxpayer has made a large investment
- Not determinative that activity is engaged in for profit
- Substantial profit, though occasional, where investment or losses are comparatively small, would indicate activity engaged in for profit

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FINANCIAL STATUS OF THE TAXPAYER PG 444

Lack of substantial income from other sources may indicate a profit activity

Substantial income elsewhere may indicate activity is not for profit, especially if the losses **offset significant other income**

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ELEMENTS OF PERSONAL PLEASURE OR RECREATION PG 444

A business isn't a hobby **merely** because it's enjoyable, but if the likelihood of **profit is small** compared to **personal gratification**, enjoyment may be the **primary motive**

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MULTIPLE ACTIVITIES PG 444

The **activity at issue** must first be identified; several undertakings may be **separate activities**, or **one** if **sufficiently interconnected**

Key facts: the degree of **organizational and economic interrelationship**, the **business purpose** served by combining or separating them, and the **similarity** of the various activities

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MULTIPLE ACTIVITIES PG 444

Where the special rule applies, the activity on the property must be **independently profitable – excluding** holding-related deductions (**rent, depreciation of improvements**)

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PRACTITIONER NOTE: ALLOCATING INCOME & DEDUCTIONS PG 445

With **more than one activity**, an item of **income or deduction** may be **allocated** among them

If **property is used in several activities** and one is **not for profit**, deductions must be **allocated on a reasonable and consistent basis**

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PRESUMPTION THAT AN ACTIVITY IS FOR PROFIT PG 445

I.R.C. § 183(d)

An activity is **presumed for profit** if profitable in **3 or more years of a consecutive 5-year period** (**2 of 7 years** for **horse** breeding, showing, training, or racing)

The presumption begins in the **third profitable year** (**second** for horses) and applies to **all subsequent years** in the period

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PRESUMPTION THAT AN ACTIVITY IS FOR PROFIT

PG 445

- The presumption is subject to a rolling evaluation
- The 5-year period updates each year
- If the presumption is met, it **shifts the burden to the IRS**
- Without it, the **taxpayer** keeps the burden

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EXAMPLE 12.10 MEETING THE PRESUMPTION

PG 445

Theodore Lynch's business: **loss 2022, profit 2023, profit 2024, loss 2025, profit 2026**

He had **3 profit years of 5**, meeting the presumption for **2026** (the third profit year)

He also meets it for **2027**, based on profits in **2023, 2024, and 2026**

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ELECTING TO POSTPONE THE DETERMINATION

PG 445

A taxpayer may **elect to postpone** the presumption determination until the **end of the fourth year** (**sixth** for horses) after the activity begins

During that time, the taxpayer files **as though the activity is for profit**

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MAKING THE ELECTION PG 446

File **within 3 years** after the (unextended) due date of the **first year's** return

No later than 60 days after an IRS notice **proposing to disallow** the activity's deductions

Use **Form 5213**; the IRS **suspends** the case until the **end of the presumption period**, then makes a **final determination**

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MAKING THE ELECTION PG 446

Form 5213 **extends the limitations period** for activity-related deficiencies during the presumption period

The period is extended **2 years after** the due date of the return for the **last year** in the **postponement period**

Only for **§ 183-related** items

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EXAMPLE 12.11
HOBBY DETERMINATION
PG 446

- **Jamie Brown** began growing **organic vegetables** on **April 5, 2024**
- Deducted expenses including a **§ 179** deduction for equipment
- She **sold vegetables in 2024 and 2025** but had **losses both years**

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EXAMPLE 12.11
HOBBY DETERMINATION
PG 446

- In **2026**, she attended the farmers' market regularly and **turned a profit**
- Received a **notice of deficiency** disallowing her 2024–2025 deductions
- Jamie **immediately filed Form 5213** to **postpone** the presumption determination (Figure 12.1)

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EXAMPLE 12.11
HOBBY DETERMINATION
PG 446

- The IRS **suspends** the case until the **end of 2028**, then reviews **2024 through 2028**
- If she profits in **2026, 2027, and 2028**, the **presumption applies** and the **IRS bears the burden**
- The IRS has until **April 15, 2030** (2 years after the 2028 return's due date) to assess any deficiency for **2024 through 2028**

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HOBBY LOSS LIMITATIONS **PG 448**

If an activity is **not for profit**, generally **no business deduction** is allowed

The taxpayer may still take deductions allowed under **other code sections**, such as **mortgage interest** [§ 163] and **real estate taxes** [§ 164(a)]

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PRACTITIONER NOTE PG 448

The **I.R.S. § 183** hobby loss limits apply to individuals, partnerships, estates, trusts and S-corporations

It does not apply to C Corporations

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HOBBY LOSS LIMITATIONS PG 448

Hobby income is reported on **Schedule 1 (Form 1040), line 8(j)**, "Activity not engaged in for profit income"

Through 2017, hobby expenses were deductible up to gross income as a **miscellaneous itemized deduction**; the **TCJA suspended** these (2%-of-AGI floor) through 2025, and **OBBBA permanently eliminated** them

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HOBBY LOSS LIMITATIONS PG 448

Even though taxpayers **cannot deduct hobby expenses** on Schedule A,

Taxpayers are still taxed on **gross income, not gross receipts**

Under **Treas. Reg. § 1.183-1(e)**, gross income includes **all gains and gross receipts** from the activity

45

45

HOBBY LOSS LIMITATIONS PG 448

Gross receipts from a hobby may be reduced by **cost of goods sold**

Cost of goods sold (COGS) represents the cost to produce or acquire inventory that has been sold

The taxpayer must **consistently** do so under **accepted accounting methods**

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CROSS REFERENCE PENALTIES FOR NONCOMPLIANCE PG 448

Treating a **hobby or startup activity** as a trade or business, with disallowed deductions, draws a **notice of deficiency** and often an **I.R.C. § 6662** accuracy-related penalty

The penalty is **20%** of any underpayment from **negligence or disregard** of the rules or a **substantial understatement** of tax

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CROSS REFERENCE PENALTIES FOR NONCOMPLIANCE PG 448

The penalty will **not be imposed** if the taxpayer had **reasonable cause** and acted in **good faith** (*see* **pages 84 to 100**, ***2023 National Income Tax Workbook***)

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Deduction for Compensation Paid P. 461

- If a family member is a **bona fide employee**, the business may **deduct wages and related expenses** (including medical benefits) on **Schedule F** or **Schedule C**
- These are **ordinary and necessary** business expenses under **I.R.C. § 162**
- These **reduce proprietorship income and SE taxes** (computed on net income)

50

Deduction for Compensation Paid Pg 461

- Family wages are generally **subject to employment taxes**, with **exceptions for a child, spouse, or parent**
- A deduction requires a **bona fide employment relationship**: the employee **performs services** and pay **reflects the value** of the work
- Compensation is deductible under **§ 162(a)** only if it is **reasonable in amount** and **solely for services rendered**

51

Reasonable for Compensation Pg 461

- Amounts **exceeding what is reasonable** for the services actually performed are **not deductible**
- Reasonableness turns on facts and circumstances: the employee's **qualifications and experience**, the **nature, extent, and scope of duties**, the **time devoted**, and **amounts paid by similar businesses** for similar services
- See **Figure 12.5**, Pg 462 for IRS Factors

52

Payment for Services Rendered Pg 462

- A family business must **document** that payments are **for services rendered**, not **nondeductible gifts or support**
- Keep records showing the **duties performed** by family member employees and the **hours worked**
- Prepare forms **W4** and **I-9** for **all** employees, **including family members**

53

Child Employed by Parents Pg 462-463

Wages are subject to **income tax withholding, social security, Medicare, FUTA & Mich UIA**(regardless of age) if the child works for:

- A **corporation**, even if controlled by the parent
- A **partnership**, even with a parent partner, **unless every partner is a parent** of the child
- An **estate**, even a deceased parent's estate

54

Child Employed by Parents Pg 463

- If the child works for a sole proprietorship or an all-parent partnership, income tax withholding is required, but **age-based employment tax rules** govern

55

Child Employees: The Age Rules Pg 463

- **Age 21 or older:** wages **subject** to social security, Medicare, FUTA, & Mich UIA, regardless of entity type
- **Under 21: not subject** to FUTA or Mich UIA
- **Under 18: not subject to** social security, Medicare, FUTA, or Mich UIA
- **All ages:** Federal & Michigan **income tax withholding** applies

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Examples 12.17-12.18: The Age Rules Applied Pg 463

- **Ex. 12.17:** Marc **(age 22)** works for sole-proprietor family business – parents withhold **social security, Medicare, and income tax**, and pay **FUTA** & **Mich UIA** if otherwise required
- **Ex. 12.18:** Liam **(age 19)**, works for sole-proprietor family business – withhold **social security, Medicare, and income tax**; **no FUTA nor Mich UIA**

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Example 12.19:
The Age Rules Applied

Pg 463

- **Ex. 12.19:** April **(age 16)**, works for her mother's sole proprietorship business – **exempt from social security and Medicare** and **no FUTA nor Mich UIA**, but **income tax withholding applies**

58

Spouse as Employee

Pg 464

- Payments for a **spouse's services** are subject to **social security, Medicare, and income tax withholding**, but **not FUTA nor Mich UIA**
- **FUTA does apply** if the spouse works for a **corporation** (even if controlled by spouse) or a **partnership** (even if spouse is a partner)

59

Spouse as Employee

Pg 464

- A spouse is an **employee** if there is an **employer/employee relationship**: the **first spouse substantially controls** the business and the **second is under their direction and control**
- A **partnership** relationship exists instead if the second spouse has an **equal say**, provides **substantially equal services**, and **contributes capital**

60

Parent Employed by Child Pg 464

Wages for a **parent** working for a **child** are subject to **social security, Medicare, and income tax withholding**, but **not FUTA nor Mich UIA** – unless the business is a **corporation, partnership, or estate**

61

Parent Employed by Child Pg 464

Example 12.21:

- Amadi Okafor's sole proprietorship employs his father **Tobi** to supervise operations
- Paid **$2,500** biweekly
- Subject to **social security, Medicare, and income tax withholding**, but **exempt from FUTA & Mich UIA**

62

Tax on Children's Earned Income Pg 464

- **Earned income** (wages, tips, pay for services) is included in the **child's** gross income, **not the parent's**
- **Deductions** for payments from a child's earnings are the **child's**, even if the parent makes them
- The child may claim the **dependent's standard deduction**

63

Tax on Children's Earned Income Pg 465

Under **§ 63(c)(5)**, a dependent's **2026** standard deduction is the **greater of**:

- **$1,350**, or
- **$450 plus earned income**, up to the **$16,100** standard deduction

64

Tax on Children's Earned Income Pg 465

A dependent typically must file if:

- **Unearned income only**, and it **exceeds $1,350**
- **Earned income only**, and it **exceeds $16,100**
- **Both**, and **gross income exceeds** the greater of **$1,350** or **$450 plus earned income** (capped at $16,100)

65

Unearned Income: The Kiddie Tax Pg 465

- The **kiddie tax** applies to a child's **unearned income** (taxable interest, ordinary dividends, capital gains)
- It **prevents parents** from **shifting unearned income** to children to avoid higher rates
- It can apply to **children under 24**

66

Unearned Income: The Kiddie Tax Pg 465

A child files **Form 8615** if the following 5 conditions apply:

1. **Unearned income over $2,700** in 2026
2. The child is **required to file** a return
3. The child **meets an age test** (next slide)
4. **At least one parent was alive** at year-end
5. The child does **not file jointly**

67

Unearned Income: The Kiddie Tax Pg 465

The child meets the age requirement if:

- **Under 18** at year-end, **or**
- **Age 18** at year-end **and** did not have **earned income over one-half of their support**, **or**
- A **full-time student, 19 to 23** at year-end, **and** did not have **earned income over one-half of their support** (excluding scholarships)

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Cross-Reference: Kiddie Tax Election Pg 465

- A **parent may elect** to report the child's **interest, ordinary dividends, and capital gain distributions** on the **parent's return**
- If so, the **child does not need to file**
- *See* **pages 389-399** of the ***2025 National Income Tax Workbook***

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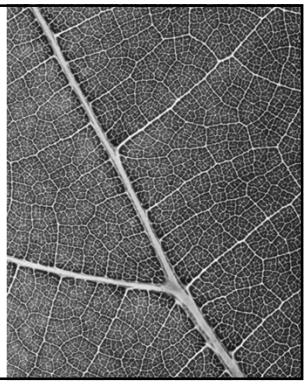
QUESTIONS?



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