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The IRS and taxpayers are often at odds over losses claimed for activities that may be characterized as a hobby. Now a new report from the Treasury Inspector General for Tax Administration (TIGTA) says the IRS can do a better job of identifying hobby losses claimed by taxpayers (TIGTA Ref. No. 2016-30-031, 4/12/16)

Generally speaking, deductions for an activity treated as a hobby are limited to the amount of income from the hobby. In other words, a taxpayer can't deduct a loss from an activity if he or she doesn't have a profit motive, although business losses are deductible. Because this represents a significant difference to taxpayers, especially to those in the highest tax brackets, disagreements often end up in court. In the latest example, the owner of a hair salon was allowed to deduct losses relating to her activities (Delia, TC Memo 2016-71, 4/20/16).

The prevailing regulations list nine critical factors for determining whether an activity constitutes a business or a hobby. They are:

- The manner in which the taxpayer carries on the activity.
- The expertise of the taxpayer or his or her advisers.
- The time and effort expended by the taxpayer in carrying on the activity.
- The expectation that assets used in the activity may appreciate in value.
- The success of the taxpayer in carrying on other similar or dissimilar activities.

- The taxpayer's history of income or losses with respect to the activity.

The new TIGTA report was initiated as a follow-up to another undertaking by TIGTA back in 2007. At that time, TIGTA said that approximately 1.2 million taxpayers may have used hobby losses to reduce their taxable incomes to potentially avoid paying $2.8 billion in taxes in 2005. The overall objective of the latest review was to determine whether the IRS is taking sufficient action to minimize improper Schedule C losses claimed by taxpayers.

In the new report, TIGTA found that the IRS doesn't maximize all the relevant and available information to identify hobby losses. Furthermore, when returns containing potential hobby losses are selected for audit, examiners don't always address hobby loss issues.

For the period spanning 2011 through 2014, TIGTA identified 9,699 individual returns from 2013 that claimed a Schedule C loss of at least $20,000, gross receipts of $20,000 or less and wages of at least $100,000. These taxpayers also reported losses in the four consecutive years. TIGTA's review of 100 returns showed that 88 percent were not engaged in for profit. It estimates that 7,511 returns in the total sample population of taxpayers may have inappropriately used hobby loss expenses to reduce taxes by as much as $70.9 million for 2013.

"Taxpayers with significant amounts of income from other sources may attempt to reduce their tax liability by including losses from activities not engaged in for profit," said J. Russell George, head of TIGTA. "The IRS needs to effectively identify these taxpayers in order to deter future non-compliance."

Accordingly, TIGTA made the following three recommendations to the IRS:

1. Use research capabilities to identify high-income individual returns with multiyear Schedule C losses and other factors indicating that the taxpayer may not have a profit motive for the activity.

2. Emphasize the importance of the required checks of filed tax returns in the