PacificCPE

COURSE

32702A

Tax Planning for Small Business: Part 2

Many small business clients operate more than one venture or run a side business alongside regular employment—each scenario creating its own set of tax challenges. This course addresses planning strategies for sideline and multiple business structures, then tackles the alternative minimum tax and other special taxes that can affect business owners in unexpected ways. Ideal for practitioners who want a broader view of how overlapping business activities and tax regimes interact for their small business clients.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify tax strategies when running a side business.
- Identify helpful strategies when running more than one business.
- Recognize the nuances of the alternative minimum tax.
- Recognize the specifics of FICA, employment taxes, and more.

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Chapter 1: TAX STRATEGIES FOR A SIDELINE BUSINESS

Chapter Objective

After completing this chapter, you should be able to:

- Identify tax strategies when running a side business.

Millions of Americans today have a sideline business. According to Bankrate.com, about 27% of Americans had side hustles in 2025. Having a sideline business has become easy with the advent of eBay, Etsy, and other onlinemarketplaces. The "gig" economy, with options for part-time and freelance work through Fiverr, Uber, TaskRabbit, Upwork, Takl, and other platforms, also provides sideline business opportunities (assuming state law does not treat you as an employee of the platform). And influencers may work on YouTube and TikTok in addition to other business activities. But sideline businesses, such as dog breeding and gentleman farming, have been around for years.

Starting and running a sideline business can be a savvy move. It is a way to supplement your current income. It may be a safety net in case of a job dislocation. And as the BOA survey shows, it can be a way to test the waters for a full-time business in the future, say, on retirement.

For a further discussion of business expenses, see IRS Publication 535, Business Expenses.

REPORTING SIDELINE BUSINESS INCOME

There’s a basic rule when it comes to income from a sideline business: You must report it. There is no minimum revenue or number of sales you must have before income becomes reportable. You must report income, whether or not it is reported to the IRS (such as on Form 1099-NEC for payments to independent contractors or Form 1099-K for merchant transactions).

Of course, all of the revenue you take in may not necessarily be profit. You can deduct expenses (subject to the limits explained throughout this course as well as the hobby loss limit, discussed next), which may mean that there is no income subject to tax.

The IRS has the Gig Economy Tax Center at https://www.irs.gov/businesses/small-businessesself- employed/sharing-economy-tax-center to help explain income reporting and other requirements for those engaged in sideline activities.

HOBBY ACTIVITIES

If your unincorporated business sustains losses year after year, you may not be able to deduct the expenses unless you can show that you have undertaken the business in order to make a profit. This limitation on deducting expenses is called the hobby loss rule, because it is designed to prevent individuals who collect coins and stamps, breed dogs or cats, or carry on other hobby activities from deducting what the tax law views as personal expenses. Any activity you do mainly for recreation, sport, or personal enjoyment is particularly suspect.

But the hobby loss rule is not limited to these types of activities. It can apply to any activity—even investment activities intended to produce only tax losses for investors. In fact, the IRS even tried to apply the hobby loss rule to a young attorney just starting her practice. The IRS argued that the losses she sustained were not deductible because of the hobby loss rule. The attorney was able to show a profit motive (proof of a profit motive is explained later), and she was allowed to deduct her losses.

The hobby loss rule applies to individuals (including partners and LLC members) and S corporations. It does not apply to C corporations. For partnerships, LLCs, and S corporations whose business losses pass through to owners, the determination of whether there is a profit motive is made at the business level rather than at the owner level. In other words, the business itself must have a reasonable expectation of making a profit. The fact that an individual owner has a profit motive does not transform a hobby activity into a deductible business expense if the business does not reasonably have a profit motive. A business may be able to establish a profit motive in one year even if this cannot be done for another year.

Impact of Hobby Classification

If your business is classified as a hobby, then you can’t deduct any expenses. You must report all of the income from the activity (it’s reported on line 8j, Schedule 1 of Form 1040 or 1040-SR as income from an activity not engaged in for profit income). But expenses cannot be deducted because they are treated as nondeductible miscellaneous itemized deductions.

Proving a Profit Motive

There is no hard and fast way for proving that you have profit motive. Rather, a profit motive is something that is inferred on the basis of various factors. The burden of proof is on you, the taxpayer. No single factor is determinative. Some or all of the factors used to determine profit motive include:

- Whether you carry on the activity in a businesslike manner. This means that you keep good books and records separate and apart from your personal records, and have a business bank account, telephone, stationery, and other indices of a business. Having a written business plan and marketing plan is also helpful. Some tax experts also believe that taking the formal steps to create a limited liability company or an S corporation helps to prove a profit motive.
- Whether the time and effort you put into the activity shows that you intend to make a profit. If you spend only a small amount of time on it, this may show that there is no realistic way in which you can make a profit.
- Whether you depend on the income from the activity for your livelihood. If you do, then obviously you hope to make a profit to live on.
- Whether you change methods of operation to improve profitability. If you get the advice of experts, this shows you want to make a profit.
- Whether the activity is profitable in some years, and how much profit is realized in those years. Certainly, an activity may not always be profitable, but if there has already been a profit in some years and that profit is substantial, this shows an expectation of continued profit.
- Whether you or your advisers have the know-how needed to carry on your business at a profit. If you undertake some activity that you enjoy but know nothing about, this may indicate a lack of profit motive.
- Whether you can expect to see a profit from the appreciation of the assets used in the activity. You may not necessarily realize profit from the operations of the business, but its assets may prove to be profitable.Arealistic expectation of this profit from the appreciation of business assets shows profit motive.

The Court of Federal Claims allowed a taxpayer with multiple activities to aggregate them in order to establish a profit motive. In other words, if one activity has a loss but is part of an overall plan to make a profit, the loss may be allowed.

Aggregation of multiple activities is permitted when the facts and circumstances support it. The most significant factors enumerated in Reg. §1.183-1(d)(1) for aggregation are:

- The degree of organizational and economic interrelationship of the activities
- The business purpose served by carrying on the activities separately or together
- The similarities of the activities

Look at the IRS Audit Technique Guide on Activities Not Engaged in for Profit at https://www.irs.gov/pub/ irs-pdf/p5558.pdf.

Presumption of a Profit Motive

Your business may not be profitable, particularly in the early or start-up years. The tax law gives you a special presumption on which you can rely to show a profit motive (and delay an IRS inquiry into your activity). An activity is presumed to be engaged in for profit if you have a profit in at least 3 out of 5 years. If the activity is breeding, training, showing, or racing horses, the presumption period is 2 out of 7 years. If you meet this presumption, then the hobby loss rules do not apply, and your losses in the off years can be claimed in excess of your income from the activity.

You can rely on this presumption and avoid having the IRS question your losses by filing Form 5213, Election to Postpone Determination as to Whether the Presumption Applies that an Activity Is Engaged in for Profit. In effect, the form asks the IRS to delay a determination of your profit motive until the end of the 5-year (or 7-year) period.

Generally, you must file Form 5213 within 3 years of the due date of the return for the year in which you first carry on the activity. You should know within this time whether you can reasonably expect to be profitable and avoid the hobby loss rules or whether you need to rely on the presumption to gain additional time for the business to make a profit.

The downside to filing this form is that it extends the statute of limitations (the period in which the IRS can question your return and assess additional taxes). In this case, the statute of limitations is extended to 2 years after the due date of the return for the last year of the presumption period. It is extended only for deductions from the activity and any related deductions. Other items on your return, such as your personal deductions, are not affected by this extension of the statute of limitations.

Is it a good idea to file Form 5213 and raise the presumption? Doing so is almost a guarantee that the IRS will look closely at your return. If you don’t show a profit in the required number of years during the presumption period, you will be forced to argue that you have a profit motive despite recurrent losses. You are probably no better off than if you had not filed the form.

BUSINESS EXPENSES

Any type of expense you could deduct for a full-time business applies to a sideline activity as well. The only question is whether the hobby loss rule limits your annual write-off.

Home Office Deduction

If you run a sideline activity from your home, you can claim a home office deduction as long as you meet the home office rules. The office does not have to be used for a full-time activity. As long as it is your principal place of business for a sideline activity and you meet other conditions for the home office deduction, you can write off related expenses.

Other Business Expenses

From start-up to shut-down and in between, expenses incurred in a sideline activity are viewed as deductible costs just as if it were a full-time business. There are no deductions barred to you merely because you do not work full-time at this activity.

WHERE TO REPORT SIDELINE INCOME AND EXPENSES

Income from a hobby activity is reported on line 8j, Schedule 1 of Form 1040 or 1040-SR. There is no additional form or schedule to complete, although you can attach your own statement explaining the income. No deductions can be claimed or carried over.