Hobby vs. Business

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Hobby or Business?

If an individual, partnership, estate, trust, or an S corporation engages in an activity that is not conducted as a for-profit business, deductions are limited to the amount of income from the activity. This rule does not apply to corporations, other than S corporations. If an activity is considered a for-profit business, deductions can exceed income, allowing the resulting loss to offset other income.

Determination

In determining whether an activity is a hobby or a business, all facts and circumstances are taken into account. No one factor can make the determination. The following list is not intended to be all inclusive.

1) ***Manner in which the taxpayer carries on the activity.*** Factors that may indicate a business include maintaining complete and accurate books and records, carrying on the activity substantially similar to other profitable activities of the same nature, and changing operating methods and techniques to improve profitability.
2) ***The expertise of the taxpayer or his or her advisors.*** Factors that may indicate a business include knowledge of the taxpayer, or consultation with those who are knowledgeable about a particular industry, then using that knowledge to try and make a profit.
3) ***The time and effort expended by the taxpayer in carrying on the activity.*** Factors that may indicate a business include spending a lot of time and effort in the activity, particularly if the activity does not have substantial personal or recreational aspects. Taking time away from another occupation may also indicate a profit motive. Spending little time will not be counted against the taxpayer if qualified employees are hired to carry on the activity.
4) ***Expectation that assets used in the activity may appreciate in value.*** Even if no profit is made from operations, if the value of land or other assets in the activity appreciate so that an overall profit is made from a sale, the activity may be considered a business.
5) ***The success of the taxpayer in carrying on other similar or dissimilar activities.*** If the taxpayer was successful in the past turning an unprofitable venture into a profitable venture, the current activity may be a business even if it has not yet made a profit.
6) ***The taxpayer's history of income or losses with respect to the activity.*** Early losses during start-up will not count against the taxpayer, but continued losses after the customary start-up stage that are not explainable may indicate a hobby. Losses sustained due to unforeseen circumstances, such as casualty or thefts beyond the taxpayer's control, will not count against the taxpayer. Any series of profitable years are strong evidence the activity is a business.
7) ***The amount of occasional profits, if any, which are earned.*** The amount of profits in relation to the amount of losses, and in relation to the taxpayer's investment in the activity, may indicate intent. An occasional small profit one year, mixed with large losses in other years or large taxpayer investments, may indicate the activity is a hobby. Substantial occasional profits mixed with frequent small losses or investment may indicate a business. An opportunity to earn substantial ultimate profits in a highly speculative venture also indicates a profit motive.

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8) ***The financial status of the taxpayer.*** If the taxpayer does not have substantial income or capital from other sources, the taxpayer may have a profit motive. If the taxpayer has substantial income from other sources, and losses from the activity in question generate substantial tax benefits, the taxpayer may not have a profit motive.
9) ***Elements of personal pleasure or recreation.*** Where there are recreational or personal elements involved with the activity, a lack of profits may indicate a hobby. On the other hand, a lack of any appeal in the activity other than possible profits indicates a profit motive. It is not necessary that the sole purpose for engaging in an activity is to make a profit. The availability of other investments that might produce a higher rate of return will not count against the taxpayer. The fact that a taxpayer derives personal pleasure in the activity is not sufficient in itself to classify the activity as a hobby if other factors indicate the activity is a business.

Presumption of Profit

IRS rules state that if an activity is profitable in three of the last five tax years, including the current year, the presumption is it is carried on for profit, and the hobby loss limitations do not apply. If the activity consists primarily of breeding, training, showing, or racing horses, the IRS will presume it is carried on for profit if a profit is produced in at least two of the last seven tax years, including the current year.

Reporting Hobby Income and Expenses

Occasional profits from hobby activities are not subject to self-employment tax, and losses from hobby activities cannot be used to offset other income.

Hobby Income

Gross income for the purposes of the hobby loss rules equals gross receipts minus the cost of goods sold deduction. Hobby income may include capital gain, rent, and other income.

Hobby Expenses

Expenses related to hobby income are reported as itemized deductions on Schedule A.

Activities Not Engaged in for Profit

IRS examiners consider the following in their analysis to determine whether or not an activity is engaged in for profit.

- Are there activities with large expenses and little or no income?
- Are losses offsetting other income on the tax return?
- Does the activity result in a large tax benefit to the taxpayer?
- Does the history of the activity show that it is generating any profit in any years?

Examples of possible hobby activities include:

– Airplane Charter	– Games
– Artists	– Gardening
– Auto Racing	– Horse Breeding
– Boating	– Horse Racing
– Bowling	– Jewelry Making
– Collecting	– Knitting
– Cooking	– Motocross Racing
– Craft Sales	– Music
– Direct Sales	– Outdoor Recreation
– Dog Breeding	– Photography
– Entertainers	– Rentals
– Farming	– Stamp Collecting
– Fishing	– Woodworking
– Fishkeeping	– Writing
– Gambling	– Yacht Charter

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 70½.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of $5,000.