

TaxBrief

Keeping you informed

Hobby or Business?

Many individuals are exploring new income sources through creative pursuits, side hustles or turning a passion into a potential business. Suppose you find yourself earning money from an activity outside of your regular job. In that case, it's essential to understand how the IRS views your activity and specifically, whether it is considered a business or a hobby. The distinction is crucial, as it directly impacts how you report your income and what expenses you can deduct on your tax return.

Why does hobby vs. business distinction matter?

The IRS treats income from hobbies and businesses very differently. If your activity is classified as a business, you can deduct a wide range of expenses, potentially reducing your taxable income and overall tax bill. If it's considered a hobby, you must report the income, but you generally cannot deduct any related expenses. This typically results in higher tax liability.

- **Business:** If the IRS considers your activity a business, you can deduct ordinary and necessary expenses, even if you have an overall loss.
- **Hobby:** If it's a hobby, you must report all income; you cannot deduct any expenses related to the activity.

How does the IRS decide?

The IRS looks at several factors to determine if your activity is a business or a hobby. No single factor is decisive. Instead, the determination is based on all the facts and circumstances, as outlined in Reg. §1.183-2(b). Here are the main things it considers:

- **Profit motive:** Do you intend to make a profit? Are you putting in an effort to improve profitability?
- **Recordkeeping:** Do you keep accurate books and records?

- **Expertise:** Do you have the knowledge or seek advice to make the activity profitable?
- **Time and effort:** How much time and effort do you put in?
- **History of income/losses:** Have you profited from similar activities before? Are losses due to circumstances beyond your control?
- **Financial status:** Do you depend on the income from this activity?
- **Personal enjoyment:** Is the activity mainly for fun or recreation?

Tip: If you made a profit in at least three out of the last five years (two out of seven for horse activities), the IRS presumes you are in business to make a profit. If not, you may still be considered a business, but you will need to demonstrate your intent to make a profit.

What if it's a hobby?

The IRS considers a hobby any activity you do mainly for fun or personal enjoyment, not to make a profit. However, if you earn money from a hobby, you must report that income on your tax return. For tax years 2018 and beyond, you cannot deduct any expenses related to the hobby, as the disallowance of miscellaneous itemized deductions is now permanent under current law.

- **Report all income** on your tax return
- **No expense deductions** are allowed for hobby activities

Example: If you sell \$2,000 worth of handmade soap on Etsy as a hobby, you must report the \$2,000 as income, but you cannot deduct the cost of materials or other expenses.

What if it's a business?

The IRS sees a business as an activity you do to make a profit. You report both your income and your related expenses on your tax return. You can deduct ordinary and necessary expenses, like supplies, advertising and even part of your home if you qualify. If your business earns a net profit of \$400 or more, you might also owe self-employment tax. You may need to make quarterly estimated tax payments if you expect to owe \$1,000 or more in tax for the year.

Real-life scenarios

The crafty one

Penny enjoys making hats in her spare time. She sells her hats at local fairs and online, earning about \$2,500 a year. She keeps detailed records, advertises her products and always looks for ways to increase sales. She made a profit in three of the last five years. Penny's activity is likely considered a business in this case, and she can deduct her expenses.

The weekend gardener

Cooper grows vegetables in his backyard and occasionally sells extra produce at a local market, earning \$500 a year. He doesn't keep records or advertise and mainly enjoys gardening as a hobby. Cooper's activity is likely considered a hobby, and he must report the \$500 as income but cannot deduct his gardening expenses.

Next steps

- **Keep detailed records.** Keep thorough records of all income and expenses, whether you think your activity is a business or a hobby.
- **Operate like a business.** If you want your activity to be treated as a business, act like a business owner. Open a separate bank account, create a business plan, advertise and seek professional advice.
- **Document your profit motive.** Keeping evidence of your efforts to make a profit, such as marketing materials, changes to your business model or consultations with experts, shows that you are operating with a genuine intent to earn income, which supports your case for being treated as a business by the IRS.

- **Review your profit history.** If you made a profit in three of the last five years (or two of seven for horse activities), the IRS generally presumes it's a business, not a hobby.
- **Consult with our office, your tax professionals.** The rules can be complex, and every situation is unique. We can review your activity, ensure you meet IRS requirements and help you take advantage of all available deductions.

Frequently asked questions

Q: What if I have a loss in my business?

A: If your activity is classified as a business, you can generally deduct losses against other income, subject to certain limitations. However, losses are not deductible if the IRS determines your activity is a hobby.

Q: Can I switch from hobby to business status?

A: Yes. If your activity changes and you begin operating more like a business with a clear profit motive, you can reclassify it as such. Document any changes you make.

Q: What if I am audited?

A: Your best defense is good records and evidence of your profit motive. We can help you prepare and respond to any IRS inquiries.

Let's review your situation together

Determining whether your activity is considered a hobby or a business can significantly impact your taxes. If you are unsure, don't leave it to chance. We are here to help you evaluate your situation, ensure you comply with IRS rules and maximize your tax benefits.

Contact us today to schedule a review of your side activity or new venture.