

Hobby vs. Business



Is Your Trade or Business a Hobby for Tax Purposes?

Webster's defines a hobby as an activity or interest pursued outside of one's regular work primarily for pleasure. For tax purposes, the classification of a "hobby" refers to an activity not engaged in for profit. In contrast, a trade or business is generally carried on to make a profit. If your activity shows a loss in some years, you must be able to show there is a profit motive to report the activity as a trade or business. You can run into trouble with the IRS reporting an activity as a trade or business when the facts and circumstances show you have a hobby for tax purposes. This distinction is important because hobby expenses are limited to hobby income and a hobby cannot generate a tax loss.

Consider consulting with your tax preparer as soon as possible if there is doubt as to what your activity is, a business or a hobby. He or she can help you make that determination by asking the following questions:

- Does the time and effort put into the activity indicate an intention to make a profit?
- Do you depend on the income from the activity?
- If there are losses, are they due to circumstances beyond your control or did they occur in the start-up phase of the business?
- Have you changed methods of operation to improve profitability?
- Do you have the knowledge needed to carry on the activity as a successful business?
- Have you made a profit in similar activities in the past?
- Does the activity make a profit in some years?
- Do you expect to make a profit in the future from the appreciation of assets used in the activity?
- What elements of personal pleasure or recreation are involved in the activity?

Looks Like I Have a Business

If an activity produces a profit for three out of five years, the activity is considered an "activity engaged in for profit." (If the activity is for horse breeding, racing, training, or showing, it must make a profit for two out of seven years.) If your activity meets this presumption, it can be treated as a business and your preparer will report the activity on the appropriate tax form (i.e., Schedule C, E, or F.) Creating an LLC, S corporation, or a partnership will not prevent you from being subject to the hobby loss provisions; only C corporations (including an LLC electing to be taxed as a C corporation) are exempt from these rules.

Looks Like I Have a Hobby

If you don't engage in the activity for profit, then the income and expenses of the activity will be reported differently on your tax return. Losses from an activity deemed to be a hobby may not be used to offset other income. A loss occurs when the expenses of the activity exceed the income. This means the allowable deductions cannot exceed the gross receipts from the activity. The gross receipts (net of cost of goods sold) are reported on Line 21, Other Income, of your Form 1040. The remaining expenses are reported on Schedule A as itemized deductions, which only provide a tax benefit to the extent that they exceed 2% of adjusted gross income.

What If I'm Audited?

Congress has requested that the IRS crack down on taxpayers who mistakenly treat their hobby as a business. One of the most important things you can do is make sure you conduct your activity in a business-like manner. For instance, have a separate checking account that only pays business expenses. When withdrawing money from the activity for yourself, make the check out to you and record it as a draw. Never pay personal expenses from your business checking account.

Consider creating a written business plan if you don't already have one. There are books and software available that will ease the process. Also, some communities have organizations that can help businesses with various types of tasks such as this. Believe it or not, this can be an enjoyable activity, and enlightening as well. You may find some new ideas simply by going through the process of creating a business plan.

If you have been reporting your losses on a business return, and the IRS believes your activity is really a hobby, you have options. You can agree with the IRS and report the activity as a hobby. This may involve changing prior-year returns in which this activity had been reported as a for-profit activity. Secondly, you can appeal your case with the Appeals department of the IRS. An Appeals officer's goal is to settle controversies without litigation, which means without going to court. Lastly, you can argue your position in Tax Court.

Resources

As you know, your tax preparer is a valuable resource. In addition, here are a couple of other resources you should be aware of:

- The IRS has compiled information for small business owners available at www.irs.gov/smallbiz.
- SCORE "Counselors to America's Small Business" at www.score.org is a nonprofit association dedicated to educating entrepreneurs and the formation, growth, and success of small business nationwide. SCORE is a resource partner with the U.S. Small Business Administration (SBA). SCORE offers free and confidential small business advice by both working and retired executives and business owners who donate time and expertise as business counselors. They also offer workshops, online toolkits, free workbooks, and help creating a business plan.



Tax Liability Consulting

2570 Idaho Street

Elko, NV 89801

Phone: 775-738-4845

Fax: 775-777-3894

www.nevadataxman.com

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National Association of Tax Professionals
PO Box 8002
Appleton, WI 54912-8002
www.natptax.com

