

Hobbies and Income Tax

Article Highlights:

- Hobby, Trade, or Business
- Profit Motive
- Factors Determining Profit Motive
- Presumption of Profit Motive
- Tax Treatment of Hobbies

Millions of U.S. taxpayers engage in hobbies such as collecting stamps or coins, refurbishing old cars, making crafts, painting or breeding horses, and the list goes on.

Some hobbies will actually generate income, and some will even evolve into businesses. The tax treatment of hobbies with income is quite different than that of a trade or business, and making the distinction can be rather complicated. The main issue here is that the IRS does not want taxpayers to write off hobby expenses under the guise of trade or businesses expenses.

So, the first question is whether the activity is a hobby, trade or business. The tax law doesn't really provide a bright-line definition of the term "trade or business," probably because no single definition will apply in all cases. But certainly, to be considered a trade or business, an activity must be motivated by the taxpayer's profit motive, even if that motivation is unrealistic. Along with a profit motive, the taxpayer must carry on some kind of economic activity.

Factors to determine profit motive – The IRS uses a series of factors to determine whether an activity is for profit. No one factor is decisive, but all of them must be considered together in making the determination.

- (1) Is the activity carried out in a businesslike manner?
- (2) How much time and effort does the taxpayer spend on the activity?
- (3) Does the taxpayer depend on the activity as a source of income?
- (4) Are losses from the activity the result of sources beyond the taxpayer's control?
- (5) Has the taxpayer changed business methods in attempts to improve profitability?
- (6) What is the taxpayer's expertise in the field?
- (7) What success has the taxpayer had in similar operations?
- (8) What is the possibility of profit?
- (9) Will there be a possibility of profit from asset appreciation?

Presumption of profit motive – There is a presumption that a taxpayer has a profit motive if an activity shows a profit for any three or more years during a period of five consecutive years. However, if the activity involves breeding, training, showing or racing horses, the period is two out of seven consecutive years. An activity that is reported on a tax return as a business but has had year after year of losses and no gains is likely to eventually come under scrutiny by the IRS.

Tax Treatment of Hobbies - While trades or businesses can have losses without restriction, if the activity is deemed to be a hobby, then special rules – frequently referred to as "hobby loss" rules – apply. Under these rules, any income from the hobby is reported on the face of the tax return, and the expenses are only deductible if a taxpayer itemizes their deductions on Schedule A. In addition, hobby expenses are limited by category as follows:

Category 1: This category includes deductions for home mortgage interest, taxes, and casualty losses. They are reported on the appropriate lines of Schedule A as they would be if no hobby activity existed.

Category 2: Deductions that don't result in an adjustment to the basis of property are allowed next, but only to the extent that gross income from the activity is greater than the deductions under Category 1. Most expenses that a business would incur, such as those for advertising, insurance premiums, interest, utilities, wages, etc., belong in this category.

Category 3: Business deductions that decrease the basis of property are allowed last, but only to the extent that the gross income from the activity is more than the deductions under the first two categories. The deductions for depreciation and amortization belong in this category.

Additional limit – Individuals must claim the amounts in categories (2) and (3) as miscellaneous deductions on Schedule A, which are subject to the 2% AGI reduction; as a result, they are not deductible for alternative minimum tax purposes.

Hobby loss rules can be complicated. If you need assistance determining whether your activity qualifies as trade or business, or whether it is subject to the hobby loss rules, please give this office a call.