Is Your Hobby a For-Profit Endeavor?

Article Highlights:

- Hobby Versus For-Profit Endeavor
- Factors Used To Determine For-Profit
- Three out of Five Rule
- Hobby Deductions

Whether an activity is a hobby or a business may not be apparent to the customers of the endeavor, but distinguishing the difference is necessary for tax purposes because the tax treatments are substantially different. The IRS provides appropriate guidelines when determining whether an activity is engaged in for profit, such as a business or investment activity, or if it is engaged in as a hobby.

Internal Revenue Code Section 183 (Activities Not Engaged in for Profit) limits deductions that can be claimed when an activity is not engaged in for profit. IRC 183 is sometimes referred to as the "hobby loss rule."

This article provides information that is helpful in determining if an activity qualifies as an activity engaged in for profit and what limitations apply if the activity was not engaged in for profit.

Is your hobby really an activity engaged in for profit? In general, taxpayers may deduct ordinary and necessary expenses for conducting a trade or business or for the production of income. Trade or business activities and activities engaged in for the production of income are activities engaged in for profit.

The following factors, although not all-inclusive, may help you determine whether your activity is an activity engaged in for profit or a hobby:

- Does the time and effort put into the activity indicate an intention to make a profit?
- Do you depend on 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?

An activity is presumed to be engaged in for profit if it makes a profit in at least three of the last five tax years, including the current year (or at least two of the last seven years for activities that consist primarily of breeding, showing, training, or racing horses).

If an activity is not for profit, losses from that activity may not be used to offset other income. An activity produces a loss when related expenses exceed income. The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations.

Hobby deductions If it is determined that your activity is not for profit, allowable deductions cannot exceed the gross receipts for the activity.

Deductions for hobby activities are claimed as itemized deductions on Schedule A and must be taken in the following order and only to the extent stated in each of the three categories:

- Expenses that a taxpayer would otherwise be allowed to deduct, such as home mortgage interest and taxes, may be taken in full.
- Deductions that don't result in an adjustment to the basis of property, such as advertising, insurance premiums, and wages, may be taken next, to the extent that gross income for the activity is more than the deductions from the first category.
- Deductions that reduce the basis of property, such as depreciation and amortization, are taken last, but only to the extent that gross income for the activity is more than the deductions taken in the first two categories.

If you have questions related to your specific business or hobby circumstances, please give this office a call.