

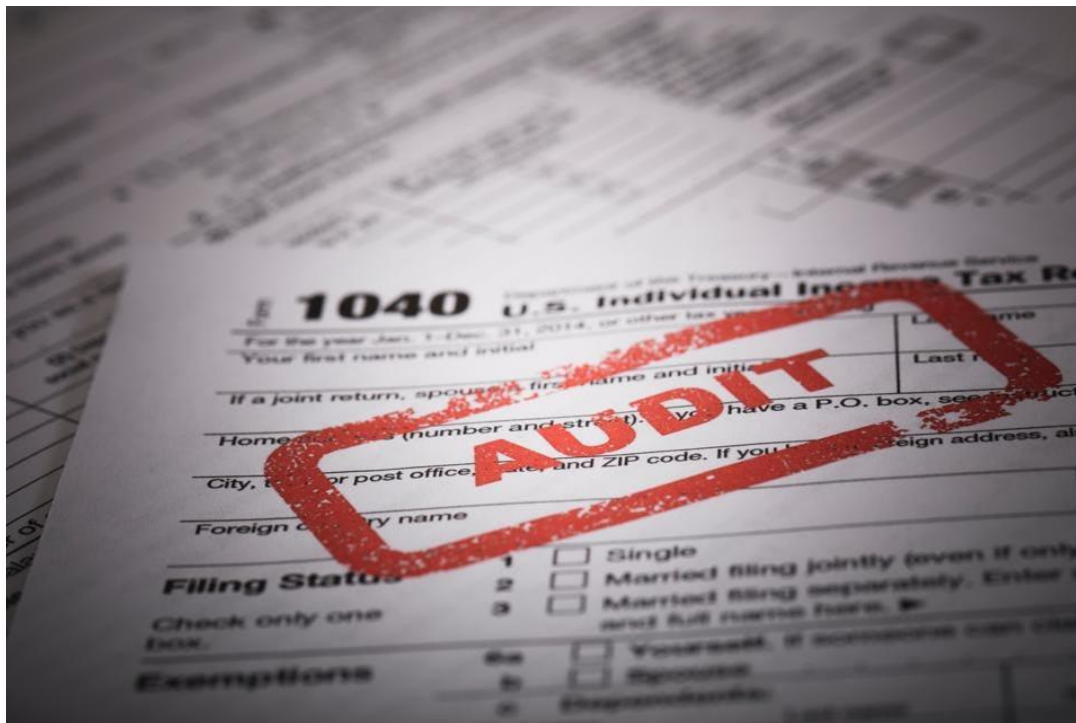
# Forbes



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### Hobby Or Business, Why It Matters To IRS & Your Taxes



Does it matter for your taxes if you spend \$500 on your hobby, or if you spend the same amount promoting your side hustle where you earn extra money? It sure does. If your activity is a hobby, your expenses are not tax deductible. But if you are running a business (even a very small business), you can write off

your expenses. That may cut your costs in half, letting the IRS pay for the other half.

As you can guess, that makes the line between hobby and business one the IRS watches carefully. Say you lose \$20,000 a year in the "business" of breeding, training and caring for whippets. You can report the loss on Schedule C to your Form 1040 and write it off against your salary. Assuming that your combined state and federal tax rate is 40%, your whippet breeding really only costs you \$12,000.

If your whippets are a hobby, you can't claim a loss. But before you decide to turn your nondeductible hobby into a deductible business, be careful. This is an area of intense IRS scrutiny. According to the IRS, the biggest difference between hobby and business is that businesses operate to make a profit, while hobbies are for pleasure or recreation.

Not everyone makes a profit right away, so the IRS says you are presumed to be operating for profit if you make a profit in 3 years out of 5. But you may still be able to convince the IRS that you are running a business, even if you have a profit in only 1 year out of 10. Still, don't expect that to be easy, and expect to have to take the IRS to court. Good records, and operating in a business like way are very important.

Whether someone is having fun with a hobby or running a business, if they accept more than \$600 for goods and services using online marketplaces or payment apps, they could receive a Form 1099-K. Profits from the sale of goods, including personal items, and services is taxable income that must be reported on tax returns.

There are a few other things people should consider when deciding whether their project is a hobby or business. No single thing is the deciding factor. Taxpayers should review all of the factors to make a good decision. These questions can help taxpayers decide whether they have a hobby or business:

- Do they carry out the activity in a businesslike manner and keep complete and accurate books and records?
- Does the time and effort they put into the activity show they intend to make a profit?
- Does the activity make a profit in some years – if so, how much profit does it make?
- Can they expect to make a future profit from the appreciation of the assets used in the activity?
- Do they depend on income from the activity for their livelihood?
- Are any losses due to circumstances beyond their control or are the losses normal for the startup phase of their type of business?
- Do they change their methods of operation to improve profitability?
- Do the taxpayer and their advisors have the knowledge needed to carry out the activity as a successful business?

Here are some tips:

**1. Match income and loss.** The IRS is less likely to question whether you're engaged in a *business* if your income from the activity exceeds your expenses.

**2. Keep good records.** It matters whether you conduct yourself in a businesslike manner. If you keep good records and hold yourself out as running a business, it will help.

**3. Show a profit three years in five.** If you can manage to eke out a profit three years out of every five (or two years out of seven, if your activity is horse breeding), the IRS will *presume* you're in business to make a profit. That presumption is worth a lot since you probably won't have to mud wrestle with the IRS over a more amorphous facts and circumstances test.

**4. Plan income and expenses.** Our tax system is annual and so are profit-and-loss determinations. You may have more control than you think over when you receive income and especially when you incur expenses. That control can help you make a profit three years out of five.

**5. Delay a profits determination.** You can elect to defer the determination of profit motive until the fourth year of your "business," or your sixth year in the case of an activity involving horses. To make this election you file a [Form 5213](#), postponing the determination of whether you've met the three-out-of-five-years profit presumption. The idea of the election is to give you time to ramp up and achieve a profit. But be careful, most advisers don't recommend this election since it could flag the profit-motive issue. Plus, it has the effect of extending the IRS statute of limitations beyond the normal three years. The IRS can examine all the years in question after the deferral period has passed.

Whether taxpayers have a hobby or run a business, good [record keeping](#) is key when it's time to file taxes. Also check out these IRS publications:

[Publication 535, Business Expenses](#)

[Publication 334, Tax Guide for Small Business \(For Individuals Who Use Schedule C\)](#)

[Small Business and Self-Employed Tax Center at IRS.gov](#) [Understanding Your Form 1099-K](#)

Check out my [website](#).