

IS IT A HOBBY OR A BUSINESS?

An avid photographer occasionally does wedding photography or sells some shots to the local paper. A stay-at-home parent with a passion for baking takes orders for birthday cakes or desserts for parties or someone who's great with crafts sells some of her creations online. Are they involved in a hobby or a business? That can be a challenging determination for taxpayers, and there are special Internal Revenue Service rules to answer that question. Here is some information to help you understand where you stand, how it affects your tax situation and help keep you in good standing with the IRS.

How does the IRS define a business?

Both hobby and business income is generally taxable. However, if your activities can be considered a business, then you can deduct the qualified expenses involved, even if they exceed the income that the business brings in. A key feature of a business is that it is undertaken to earn a profit. In the eyes of the IRS, an activity is presumed to be carried on for a profit if it has made a profit in at least three of the last five tax years, including the current year. (There's a slightly longer horizon for businesses that involve breeding, showing, training or racing horses.) If you haven't had the three years or more of profits, the IRS may take nine other factors into account. They include:

1. Whether you carry on the activity in a businesslike manner;
2. Whether the time and effort you put into the activity indicate you intend to make it profitable;
3. Whether you depend on income from the activity for your livelihood;
4. Whether you can expect to make a future profit from the appreciation of the assets used in the activity;
5. Whether you change your methods of operation in an attempt to improve profitability;
6. Whether you or your advisors have the knowledge needed to carry on the activity as a successful business;
7. Whether you were successful in making a profit in similar activities in the past;
8. Whether the activity makes a profit in some years and how much profit it makes; and
9. Whether your losses are due to circumstances beyond your control (or are normal in the startup phase of your type of business).

The IRS will weigh your answers to these questions, consider your specific circumstances and come up with a determination for each situation. Your CPA can advise you not only on whether you likely qualify as a business under IRS rules, but also on the best strategic steps you can take to strengthen your company and put it on the road to greater productivity and profitability.

How does the IRS define a hobby?

A hobby is something you do because you enjoy it, without necessarily expecting to make a profit. Hobby expenses are not deductible. Hobby expenses that exceeded hobby income are disallowed as nondeductible hobby losses. Prior to Jan. 1, 2018, hobby expenses were deductible up to hobby income. These expenses were taken as a miscellaneous deduction subject to 2% of adjusted gross income. In addition, the expenses must have been considered ordinary and necessary. An ordinary expense is one that is common and accepted for the activity. A necessary expense is one that is appropriate for the activity.

There is an estimated \$30 billion a year in unpaid taxes, according to the IRS, and the incorrect deduction of hobby expenses contributes to that total. Your local CPA can help ensure your tax return accurately reflects your activities and work with you to take steps that can help minimize your tax bill and achieve your other financial planning goals. If you don't have a CPA, get a free referral and free 30-minute consultation in Oklahoma at www.FindYourCPA.com.