Business or Hobby? Answer Has Implications for Deductions

Internal Revenue Service Fact Sheet -- FS-2007-18, April 2007

The Internal Revenue Service reminds taxpayers to follow appropriate guidelines when determining whether an activity is a business or a hobby, an activity not engaged in for profit.

In order to educate taxpayers regarding their filing obligations, this fact sheet, the eleventh in a series, explains the rules for determining if an activity qualifies as a business and what limitations apply if the activity is not a business. Incorrect deduction of hobby expenses account for a portion of the overstated adjustments, deductions, exemptions and credits that add up to $30 billion per year in unpaid taxes, according to IRS estimates.

In general, taxpayers may deduct ordinary and necessary expenses for conducting a trade or business. An ordinary expense is an expense that is common and accepted in the taxpayer's trade or business. A necessary expense is one that is appropriate for the business. Generally, an activity qualifies as a business if it is carried on with the reasonable expectation of earning a profit.

In order to make this determination, taxpayers should consider the following factors:

- Does the time and effort put into the activity indicate an intention to make a profit?
- Does the taxpayer depend on income from the activity?
- If there are losses, are they due to circumstances beyond the taxpayer's control or did they occur in the start-up phase of the business?
- Has the taxpayer changed methods of operation to improve profitability?
- Does the taxpayer or his/her advisors have the knowledge needed to carry on the activity as a successful business?
- Has the taxpayer made a profit in similar activities in the past?
- Does the activity make a profit in some years?
- Can the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?

The IRS presumes that an activity is carried on for profit if it makes a profit during at least three of the last five tax years, including the current year — 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.

Deductions for hobby activities are claimed as itemized deductions on Schedule A (Form 1040). These deductions must be taken in the following order and only to the extent stated in each of three categories:

Deductions that a taxpayer may take for personal as well as business activities, such as home mortgage interest and taxes, may be taken in full.

Deductions that don’t result in an adjustment to basis, such as advertising, insurance premiums and wages, may be taken next, to the extent gross income for the activity is more than the deductions from the first category.

Business deductions that reduce the basis of property, such as depreciation and amortization, are taken last, but only to the extent gross income for the activity is more than the deductions taken in the first two categories.

Further information is available in IRS Publication 551, Business Expenses.