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<u>Is my business ***really*** a hobby?</u>

Taxpayers must follow appropriate guidelines when determining whether an activity is engaged in for profit, such as a business or investment activity or 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.”

Taxpayers may need a clearer understanding of what constitutes an activity engaged in for profit and the tax implications of incorrectly treating hobby activities as activities engaged in for profit. This educational fact sheet provides information for 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 to 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 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.

What are allowable hobby deductions under IRC 183?

If your activity is not carried on for profit, allowable deductions cannot exceed the gross receipts for the activity.

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 claim for certain personal expenses, 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 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 gross income for the activity is more than the deductions taken in the first two categories.

See: Publication 535, Business Expenses and FS-2008-23, June 2008.

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