

Is Your Activity a Hobby or a Business?

An individual who conducts an activity as a for-profit business is allowed to deduct expenses that are ordinary and necessary in carrying on the trade or business. If expenses exceed income, the loss is deductible against other income (such as wages, interest, dividends, etc.) However, if a loss is attributable to an activity *not engaged in for profit*, the loss is not allowed as a deduction against other income.

An activity is presumed to be a for-profit business if gross income exceeds deductions for three or more out of five consecutive years. If a profit is not made in at least three out of five years, the taxpayers must prove that it is a for-profit business under the facts and circumstances test for it to be characterized as a trade or business. Similarly, even though an activity has met the three-out-of-five-years-profits test, the IRS can challenge the profit motive presumption if the facts indicate that the activity is not a business.

Facts and Circumstances Test

Factors below are not intended to be an exclusive list and should be considered together to determine if a profit motive exists.

1. The manner in which the taxpayer carries on the activity.
2. The expertise of the taxpayer or advisors.
3. Time and effort spent by taxpayer in carrying on the activity.
4. The expectation that assets used may appreciate in value.
5. Taxpayer's success in other similar or dissimilar activities.
6. Taxpayer's history of income/loss with respect to the activity.
7. Amount of occasional profits, if any.
8. Financial status of the taxpayer.
9. Elements of personal pleasure or recreation are involved.

Helpful Tips

1. Keep thorough and businesslike books.
2. Use a separate business checking account.
3. Record business and personal use of assets in a log book.
4. Use a separate credit card for business.
5. Research market/technology trends used in similar businesses.
6. Obtain the insurance, registration, certification, proper license, etc. needed for that type of business.
7. Maintain a qualified home office with a second telephone listing.
8. Document periodic evaluations of operations to attempt to improve the business's profitability.
9. Develop a written business plan and update it annually.