

O'Neil & Steiner, PLLC

Self-Employed vs. Hobby Classifications

When an enterprise consistently generates losses (deductions exceed income), the IRS may step in and say it's a hobby - an activity not engaged in for profit-rather than a business.

What are the practical consequences of being a "hobby" for tax purposes? In the past this classification would mean you had to itemize your expenses and limit them to the revenue generated by your enterprise. However, due to recent tax reform legislation the consequences for 2018 and future years are much worse.

One of the items eliminated by the TCJA passed in December of 2017, that became effective for tax year 2018, were miscellaneous itemized deductions. This means expenses related to a hobby will no longer be deductible. If the enterprise is not a for-profit business activity you will be required to pay tax on the revenue generated, but you will not be able to deduct expenses related to it.

There are two ways to avoid the hobby loss rules. The first way is to show a profit in at least three out of five consecutive years (two out of seven years for breeding, training, showing, or racing horses). The second way is to run the venture in such a way as to show that you intend to turn it into a profit-maker, rather than operate it as a mere hobby. The IRS regulations themselves say that the hobby loss rules won't apply if the facts and circumstances show that you have a profit-making objective.

How can you prove that you have a profit-making objective? In general, you can do so by running the new venture in a businesslike manner. More specifically, IRS and the courts will look to the following factors: how you run the activity; your expertise in the area (and your advisers' expertise); the time and effort you expend in the enterprise; whether there's an expectation that the assets used in the activity will rise in value; your success in carrying on other similar or dissimilar activities; your history of income or loss in the activity; the amount of occasional profits (if any) that are earned; your financial status; and whether the activity involves elements of personal pleasure or recreation.

Generating a profit is the best way to establish your for-profit status.

If you are vulnerable to hobby classification based on the above information you may do better to put your time and energy into working for another entity, increasing revenues, decreasing expenses, or making other changes to business management/operations.

If you have questions or want to discuss this in greater detail, please contact the office to schedule a consultation.