

Abstract: The tax implications of earning money from an activity will vary depending on whether it is considered a hobby or business by the IRS. And the rules recently changed under the Tax Cuts and Jobs Act. This article reviews the hobby vs. business distinction and explains what's new.

Business vs. hobby: The tax rules have changed

If you generate income from a passion such as cooking, woodworking, raising animals — or anything else — beware of the tax implications. They'll vary depending on whether the activity is treated as a hobby or a business.

The bottom line: The income generated by your activity is taxable. But different rules apply to how income and related expenses are reported.

Factors to consider

The IRS has identified several factors that should be considered when making the hobby vs. business distinction. The greater the extent to which these factors apply, the more likely your activity will be deemed a business.

For starters, in the event of an audit, the IRS will examine the time and effort you devote to the activity and whether you depend on income from the activity for your livelihood. Also, the IRS will likely view it as a business if any losses you've incurred are because of circumstances beyond your control, or they took place in what could be defined as the start-up phase of a company.

Profitability — past, present and future — is also important. If you change your operational methods to improve profitability, and you can expect future profits from the appreciation of assets used in the activity, the IRS is more likely to view it as a business. The agency may also consider whether you've previously made a profit in similar activities. Also, the intent to make a profit is a key factor.

The IRS always stresses that the final determination will be based on all the relevant facts and circumstances related to your activity.

Changes under the TCJA

Under previous tax law, if the activity was deemed a hobby, you could still generally deduct ordinary and necessary expenses associated with it. But you had to deduct hobby expenses as miscellaneous itemized deduction items, so they could be written off only to the extent they exceeded 2% of adjusted gross income (AGI).

All of this has changed under the Tax Cuts and Jobs Act (TCJA). Beginning with the 2018 tax year and running through 2025, the TCJA eliminates write-offs for miscellaneous itemized deduction items previously subject to the 2% of AGI threshold.

Thus, if the activity is a hobby, you won't be able to deduct expenses associated with it. However, you must still report all income from it. If, instead, the activity is considered a business, you can deduct the expenses associated with it. If the business activity results in a loss, you can deduct the loss from your other income in the same tax year, within certain limits.

An issue to address

Worried the IRS might recharacterize your business as a hobby? Contact our firm. We can help you address this issue on your 2018 return or assist you in perhaps filing an amended return, if appropriate.

© 2019