Is your money-losing activity a hobby or a business?

Let's say you have an unincorporated sideline activity that you consider a business. Perhaps you offer photography services, create custom artwork or sell handmade items online. Will the IRS agree that your venture is a business, not a hobby? It's an essential question for tax purposes.

If the expenses from an activity exceed the revenues, you have a net loss. You may think you can deduct that loss on your personal federal income tax return with no questions asked. Not so fast! The IRS often claims that money-losing sidelines are hobbies rather than businesses — and the federal income tax rules for hobbies aren't in your favor.

TCJA made tax rules worse

Old rules: Before the TCJA rules kicked in in 2018, if an activity was deemed to be a not-for-profit hobby, you had to report all the revenue on your Form 1040. You could deduct hobby-related expenses, such as itemized deductions for allocable home mortgage interest and property taxes. Other hobby-related expenses — up to the amount of revenue from the hobby — could *potentially* be written off. You had to treat those other outlays as miscellaneous itemized expenses that you could only deduct to the extent they exceeded 2% of your adjusted gross income (AGI).

Current rules: For 2018 through 2025, the TCJA suspends write-offs for miscellaneous itemized deduction items previously subject to the 2%-of-AGI deduction threshold. That change wipes all deductions for hobby-related expenses, except for expenses you can write off in any event (such as itemized deductions for allocable mortgage interest and property taxes). So, under current law, you can't deduct any hobby-related expenses. As was the case before the TCJA, you must still report 100% of hobby-related income on your Form 1040. So, you'll be taxed on all the income even if the activity loses money.

Determine if your activity is a business

Now you understand why for-profit business status is more beneficial than hobby status. The next step is determining if your money-losing activity is a hobby or a business.

There are two statutory safe-harbor rules for determining if you have a for-profit business:

- An activity is presumed to be a for-profit business if it produces positive taxable income in at least *three out of every five* years. You can deduct losses from the other years because they're considered business losses.
- A horse racing, breeding, training or showing activity is presumed to be a for-profit business if it produces positive taxable income in at least *two out of every seven* years.

If you don't qualify for one of the safe-harbor rules, you may still be able to treat the activity as a for-profit business and rightfully deduct the losses. You must demonstrate an honest intent to make a profit. Here are some of the factors that can prove (or disprove) such intent:

- You conduct the activity in a business-like manner by keeping good records.
- You have expertise in the activity or hire advisers who do.
- You spend enough time to help show the activity is a business.
- There's an expectation of asset appreciation.
- You've had success in other ventures, which indicates business acumen.
- The history and magnitude of income and losses from the activity help show it's a business. Losses caused by unusual events are more justifiable than ongoing losses that only a hobbyist would endure.
- If you're wealthy, it may look like you can afford to absorb ongoing losses, which may indicate a hobby.
- If the activity has elements of personal pleasure, it may appear to be a hobby.

Don't be discouraged

On the bright side, the U.S. Tax Court has, over the years, concluded that a number of pleasurable activities could be classified as for-profit business ventures rather than tax-disfavored hobbies. We may be able to help you create documentation to prove that your money-losing activity is actually a for-profit business that hasn't paid off yet.