Don’t let the IRS treat your sideline as a hobby

Do you operate a side gig in addition to your regular day job? Whether you’ve turned a love for crafting into an online store or you play the guitar at a local venue, you’ll need to report the income from your sideline activity on your tax return. But can you deduct the related expenses? The answer depends on whether the IRS classifies your activity as a business or a hobby. Let’s take a closer look.

Why the distinction matters

If your activity incurs significant expenses — or even losses in some years — how the IRS classifies it can have a major impact on your taxes. *For-profit businesses* can deduct “ordinary and necessary” business expenses.

So, if you operate an unincorporated for-profit business activity that generates a net tax loss for the year (deductible expenses in excess of revenue), you can use the loss to offset income from other sources, such as salary and self-employment income, subject to annual limits. In 2026, the limit is $256,000 ($512,000 for married couples filing jointly). You can carry any excess losses forward to later tax years.

Conversely, *hobbies* receive less favorable treatment. Before 2018, hobby expenses could be claimed as miscellaneous itemized deductions subject to the 2% of adjusted gross income floor. Recent tax law changes permanently repealed itemized deductions for miscellaneous business expenses. So you generally can’t deduct hobby-related expenses for federal income tax purposes — even though you’re still required to report 100% of hobby-related income.

Potential safe harbors for profitable ventures

If you can show a profit motive for your sideline activity, the IRS will classify it as a for-profit business, and you can generally write off related expenses as the cost of doing business. Two safe harbors create a presumption that an activity is engaged in for profit:

1. Your activity produces positive taxable income (revenues in excess of deductions) for at least three out of every five years.
2. You're engaged in a horse racing, breeding, training or showing activity, and your activity produces positive taxable income in at least two out of every seven years.

Proactive tax planning can help you qualify for these safe harbors — and earn the right to deduct your losses in unprofitable years.

Factors that demonstrate a profit motive

If you aren't eligible for one of the safe harbors but can demonstrate an honest intent to make a profit, you may still be able to treat your side gig as a for-profit business. After all, many start-ups take years to become profitable. Questions the IRS considers when determining whether your activity is a business or a hobby include:

- Do you carry on the activity in a business-like manner?
- 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, did they occur due to circumstances beyond your control or in the start-up phase of the business?
- Have you changed methods of operation to improve profitability?
- Do you (or your advisors) 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?

The degree of personal pleasure you derive from the activity is also a factor. For example, most people would say that woodworking is more fun than working in a high-stress executive position — so the IRS is far more likely to classify the former is a hobby if you start claiming recurring losses on your tax returns.

Year-by-year determination

The IRS tests each year separately when determining whether an activity is a for-profit business or a hobby. So what once was considered a hobby can become a business — and vice versa. However, you generally bear the burden of proving your profit motive each year.

For example, you might be able to persuade the IRS that you've established a profit motive by keeping more detailed records, advertising and devoting more time to your side gig. It also helps to report profits for a few years, rather than just recurring losses. In fact, a pattern of losses over multiple years can sometimes trigger IRS scrutiny of whether an existing business is operating with a profit motive.

Start planning now

If you have a side business that isn't yet profitable, we can evaluate your situation and offer suggestions to help improve your odds of business tax treatment. But don't wait until year end — many factors the IRS considers when evaluating your profit motive require proactive planning throughout the year. We can help strengthen your position in case the IRS questions your deductions. Contact us to learn more.