

## It's your business



It can be great fun to take a hobby you're passionate about and use it to generate income. But if you plan to take tax deductions for your hobby expenses, be aware that the IRS has strict rules about business deductions.

### Will the IRS say "business" or "hobby"?

If your activities constitute a business, then your expenses, including depreciation, may be tax-deductible. As a hobby, these expenses are subject to limitations. Business losses are tax-deductible and can be used to offset other taxable income. Hobby losses cannot.

The IRS defines a hobby as an activity not engaged in for profit. So how can you prove you're trying to run a money-making business?

One test you're probably familiar with is the general rule of earning a profit in three of the past five years. If your business has more income than deductions in three of five consecutive taxable years, the IRS generally accepts that you have a profit motive. (The time frame is two years in seven for certain horse-related activities.)

Unable to meet that test? Additional factors play a role as well. Here are some of the determining factors.

- *Examine your conduct.* Even if your business loses money, you may be able to deduct the losses if you can show that you were engaged in this activity with the intent of making a profit.

- *Keep good books.* You must keep accurate books and records, and conduct the activity as a business. If your recordkeeping is haphazard, it will probably be difficult for you to demonstrate that your activity was a business rather than a hobby.

- *Have a plan.* It's a good idea to develop and maintain an up-to-date business plan. This plan could include projections of future income and expenses, marketing strategies, personnel policies,

and so forth. The idea is to show the IRS that you plan to grow your business.

- *Watch the clock.* Document the time you invest in this activity. The amount of time you spend in relation to other activities will, in part, determine whether this activity qualifies as a business.

- *Watch your bank account.* Keep your business and personal funds separate. Don't pay for Johnny's bicycle from your business account; don't deposit sales income into your personal account.

- *Experience counts.* Past experience with similar activities, especially if they were profitable, may be an indicator that this activity is more than a hobby.

- *Fun is bad.* If the activity has elements of personal pleasure or recreation, it may be more heavily scrutinized by the IRS. However, the facts and circumstances of the individual case are what matter.

If you hope to deduct any losses resulting from a sideline business, be certain that you are doing all that is necessary to meet the requirements of running the activity in a business-like manner. For more details or assistance, give us a call.

