

# Make your hobby pay for itself

By [Kay Bell](#) • Bankrate.com

Hobbies provide a great way to relax from the daily grind. For many people, they also offer a way to make extra spending money.

Be aware, however, when your hobby produces income, you owe tax on it.

You can reduce your taxable hobby income by deducting your hobby expenses, but this tax break is limited.

## Allowable hobby deductions

You can only deduct expenses up to the amount of money you make on the hobby. Even then, hobby expenses, along with other miscellaneous expenses you itemize on Schedule A, must come to more than 2 percent of your adjusted gross income before you can deduct them.

If you find you are regularly making money from your hobby, it might be to your tax advantage to turn the sideline into a business.

It's not as difficult as you might think. If you operate as a sole proprietor, you report the income on your Form 1040 tax return and you have more options when it comes to deducting your expenses.

## Hobby vs. business

The Internal Revenue Service defines a hobby as an activity you pursue without expecting to make a taxable profit. Basically, you do it because you like it, regardless of the cost.

But if you demonstrate that you are involved in an activity with the expectation of making money on it, the IRS will consider it a business. As such, you'll be able to deduct expenses directly from your income. You even can deduct overall business losses in the years you don't turn a profit.

You must, however, make the right moves to convince the IRS that your sideline is a legitimate business.

## What constitutes a business

The IRS uses two tests in determining whether your activity is a business or a hobby.

First, the profit test demands that you show you earned money on the activity in three out of five years.

If you can't meet the profit test, you get another chance to convince the IRS that you are running a business by passing the factors-and-circumstance test. Here, the tax agency takes a subjective, individualized look at your pursuit.

## What the IRS examines

- Whether you carry on the activity in a businesslike manner. This includes, for example, keeping good books and records, promoting your business and holding down costs where possible.
- How much time and effort you devote to the enterprise.
- Whether you depend on income from the activity for your livelihood.
- If your losses are due to circumstances beyond your control or are normal for a business in its startup phase.
- Whether you change your methods of operation in an attempt to improve profitability.
- The knowledge and background you (or your advisers) have in running such a business.
- If you were successful in making a profit in similar activities in the past.
- Whether the activity makes a profit in some years and, if so, how much.
- Whether you can expect to make a future profit from the appreciation of the assets used in the activity.
- The element of personal pleasure involved in the activity. That doesn't mean you can't enjoy your new business, but you better be getting more out of it than just a good time.

## IRS looks at everything

In determining whether you are carrying on an activity for profit, the IRS says all the facts are taken into account. No one factor alone is decisive. So be prepared to come through in several areas to convince the IRS that you're

making a good-faith attempt to run a business and not just looking to illegally claim the more-expansive business tax breaks.

By successfully transforming your hobby into a business, you'll be able to deduct your associated expenses on Schedule C or C-EZ without worrying about a percentage limitation. You might even find a few more you can take, such as one for the home office you set up to take care of your new endeavor's administrative chores.

And if you have an occasional year where you lose money, the loss can help reduce your other income and lower your tax bill.

## What is an enrolled agent?

Enrolled agents (EAs) are America's tax experts. EAs are the **only** federally-licensed tax practitioners who specialize in taxation and also have **unlimited** rights to represent taxpayers before the Internal Revenue Service.

## What are the differences between enrolled agents and other tax preparers?

An enrolled agent is a person who has earned the privilege of representing taxpayers before the Internal Revenue Service by either passing a stringent and comprehensive examination covering both individual and business tax returns, or through experience as a former IRS employee.

## Enrolled agent status is the highest credential the IRS awards.

Individuals who obtain this elite status must adhere to ethical standards and enrolled agents, like attorneys and certified public accountants (CPAs), have unlimited practice rights. This means they are unrestricted as to which taxpayers they can represent, what types of tax matters they can handle, and which IRS offices they can represent clients before.

# Is It A Hobby or A Business?



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