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### **Are You Running a Business or a Hobby?**

Are you wondering why I'm even asking this question? Whether you are running a business or indulging in a hobby concerns the IRS if you are taking deductions for business expenses or taking a loss on your income taxes. Many unemployed people or underemployed people are trying to turn a hobby into a business. But some of them are trying to claim that a hobby is a business so they can take the tax deductions.

Hobbies usually cost you money for supplies. Maybe you travel to get more information about your hobby or to see how someone else does your hobby. According to the tax code, expenses for hobbies are not tax deductible to the extent that they exceed the income you earn from your hobby.

But, what if you were to classify your hobby as a business? Now, your expenses for supplies and travel are totally deductible. Now, if your business does not show a profit, you can take the loss as a business loss against your other income and lower your taxable income. Sounds great, right?

The IRS states that if your activities, no matter whether you call them a hobby or a business, must be engaged in with the intent to make a profit. It is understood that, especially in the first years of a business, it may lose money. And that is acceptable to the IRS. But, if your business has never shown a profit, the IRS will classify your business as a hobby and disqualify your deductions and business losses.

If the IRS suspects that you are classifying your hobby as a business, it will look at your past five (5) years of tax returns. If you haven't made a profit in three (3) out of the past five (5) years, it will likely re-classify your business as a hobby. If you don't meet this test, or you haven't been in business for five (5) years, the IRS has a second test. It looks at whether you appear to be running a real business.

How do you show the IRS that you are running a real business that maybe isn't doing well? Are you keeping records of income and expenses in a systematic way (the way that businesses usually keep their records)? Do you have a separate bank account for your business? Do you market your business? Do you have all of the necessary business licenses and permits? Are you spending most of your free time on this business or do you spend time on it when you feel like it? If you are in business for a few years, are your losses getting smaller? Do you look as if you are moving towards profitability? If your business is still showing a loss, have you changed anything about how you run your business to show you are trying to make a profit?

The IRS has seen many "businesses" that are actually hobbies. They know what real businesses look like and what hobbies look like. If you are really running a business, you should look like a business. If you think you will be able to fool the IRS, think again. And don't forget that if your hobby makes you money, you have additional

income that is reportable on your income tax return and on which you must pay income tax.

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