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Business or Hobby? Why the Difference Matters

Are you always being asked to take pictures at family events because of your passion for photography? Or do you earn a steady income collecting and selling stamps or baseball memorabilia? Were you aware that there are tax implications when you earn money from a hobby? If not, or if you're unsure of all the rules, the Tennessee Society of CPAs provides these insights on why the distinctions between hobbies and businesses matter and what you need to know if your hobby becomes a business.

Define Your Terms

According to the Internal Revenue Service, a hobby is something you do for sport or recreation, not to make a profit. A business is something you do to make a profit. The IRS considers nine factors to help distinguish between a business and a hobby. They include whether you carry on the activity "in a businesslike manner," whether the time and effort you put into the activity indicate you intend to make it profitable, and whether you depend on the income from the activity for your livelihood. In addition, the IRS considers factors such as your qualifications to carry on the activity as a successful business, whether you've made a profit at similar activities in the past, and whether the activity makes a profit and how much profit it makes. As a general

rule, the IRS will consider your activity as a business if makes a profit in at least three of the last five tax years, including the current one.

Handling Hobby Income

Even if your endeavor meets the definition of hobby, you will have to pay taxes on any income it generates. The good news is that, within certain limits, you can also deduct expenses from that income. Generally, they include costs that can be considered ordinary, meaning they are common and accepted for the hobby, and costs that are necessary or appropriate for the activity. You can typically deduct hobby-related expenses up to the amount of your hobby income. If your expenses exceed your income, the additional costs would be considered personal losses and would not be deductible. If you want to deduct hobby expenses, you will have to itemize; your CPA can help you with this.

Becoming a Business

If your hobby has the potential to turn into a full-time occupation, you may find yourself considering turning it into a business. If you plan to be a sole proprietor, your business structure and tax reporting can be relatively simple. You can even file for the protections offered by a limited liability company without excessive paperwork or costs. Your CPA can explain the choices and offer advice that can help you make the best choice for your circumstances. As you make your decision, issues to consider include whether you will need to make an investment—in new equipment, work space, marketing and more—to support new activities. Will you realistically be able to generate the income necessary to justify that investment, support the business going forward and make a reasonable profit? Will you be able to run the business in

your spare time if you plan to continue to work a regular job as well? If you expect to quit your job, will you earn enough in the early years to cover your living expenses? These are just a few of the many questions that budding entrepreneurs should ask before getting started.

Your CPA Can Help

Fortunately, your local CPA can provide all the advice you need on any financial issues, from simple tax matters to becoming an entrepreneur. Turn to him or her with all your financial questions.

About Money Management

Money Management is a column on personal finance that is a joint effort of the AICPA and the Tennessee Society of CPAs, as part of the profession's nationwide 360 Degrees of Financial Literacy program. Members of TSCPA are CPAs residing and practicing primarily in Tennessee in all areas of public accounting, education, government, business and industry. TSCPA offers a speakers bureau for many types of business and educational engagements. For details, visit www.tscpa.com. TSCPA is headquartered in Brentwood, Tenn.