

## DON'T BE CAUGHT OFF GUARD BY THE TAX AND LEGAL CONSEQUENCES OF YOUR NEW QUARANTINE HOBBY (PART 2 OF 3)

The coronavirus pandemic has forced most of us to stay home, and as a result, we are all looking for hobbies to pick up while we are social distancing. For some, quarantine hobbies have become Netflix binge watching or mastering bread baking. For others, creative passions and hobbies such as selling handmade crafts on Etsy or unwanted junk on eBay have become sources of income. If you are dabbling in a quarantine hobby that produces income, this article will address the tax-filing consequences, so they do not catch you off guard.

For helpful tips on choosing a legal structure for your business to better protect yourself and your business, check out part 1 of our series (linked [here](#)). Part 3 of our series will discuss good business practices for running your business.

### **Is it a Hobby or is it a Business?**

The rules for how to report the income and expenses of your activity depend on whether you and the IRS classify your activity as a hobby or as a business for tax purposes. Distinguishing between a hobby and a business is not an exact science. In fact, the IRS's definition of a hobby is not entirely helpful, since it simply classifies a hobby as an activity that you engage in "for sport or recreation, not to make a profit."

Nevertheless, the IRS has provided a nonexclusive list of nine factors to be used in determining whether an activity is a legitimate business or a hobby:

1. Do you carry on the activity in a businesslike manner and maintain complete and accurate books and records?
2. Does the time and effort you put into the activity indicate an intention to make a profit?
3. Do you depend on income from the activity for your livelihood?
4. Are there losses? Are they due to circumstances beyond your control (or are they normal in the startup phase of your type of business)?
5. Have you changed your methods of operation to improve profitability?
6. Do you or your advisors have the knowledge needed to carry on the activity as a successful business?
7. Were you successful in making a profit in similar activities in the past?
8. Does the activity have the ability to make a profit in the next few years?

9. Can you expect to make a future profit from the appreciation of the assets used in the activity?

Additionally, the IRS provides a safe-harbor rule that presumes an activity to be a business versus a hobby if it has a profit in at least three of the last five years. If you have answered yes to a few of these questions or you have met the safe-harbor rule, then you most likely have a business. But if you answered no to the majority of these questions and you do not meet the safe-harbor rule, the IRS will most likely classify your activity as a hobby. The tax implications of each are explained further below.

### **Activity Classifies as a Hobby**

If your activity is classified as a hobby, you will have to report any income you make from that hobby on your personal tax return, Form 1040, on Schedule 1, line 8, "Other Income." The income reported will be subject to income tax but not subject to self-employment tax (an additional 15.3%) as it would be if it were classified as a business.

The downside of classifying an activity as a hobby is that you cannot deduct any hobby-related expenses. Due to a change made as part of tax reform (the elimination of miscellaneous itemized deductions under the Tax Cuts and Jobs Act (TCJA)), beginning in 2018 and continuing to 2025 unless the TCJA is otherwise extended, you are no longer eligible to take a deduction for hobby expenses. This means that under the TCJA you cannot deduct any hobby expenses, but you still must report 100% of any revenue from the hobby activity as income and pay income taxes on it. And since you cannot use hobby expenses to reduce your hobby income, you will not be able to use a loss from hobby sales to reduce other income. This can be important if you make money in other activities that you intended to offset with losses.

### **Activity Classifies as a Business**

If your activity classifies as a business or your hobby becomes a business, you are subject to a whole distinct set of tax rules. First, you will typically have to report your net income on Schedule C on your personal tax return, Form 1040. Your net income is the money you make selling your items *minus* eligible business expenses. Therefore, unlike an activity classified as a hobby, you can deduct eligible business expenses. This is a great benefit because eligible business expenses lower your taxable income, thereby lowering the amount of tax you owe as part of your tax return.

However, to be a deductible expense, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your trade or business. A necessary expense is one that is helpful and appropriate for your trade or business. Typical deductible eligible business expenses for online sellers include expenses such as:

- Fees paid to the online site/marketplace
- Cost of materials and equipment
- Shipping costs
- Bank fees
- Use of dedicated space in your home/studio for a workshop
- Legal and professional fees

To find out what deductions are available to claim and how to correctly claim those deductions, it is especially important to keep detailed records of all expenses and consult a professional, like a CPA or tax attorney. In addition, [IRS Publication 535, \*Business Expenses\*](#), is a great resource that discusses common business expenses and explains what is and is not deductible.

Although you can deduct eligible business expenses if your activity classifies as a business, you could be subject to self-employment taxes. If the net income you report on your Schedule C is \$400 or more, unlike an activity classified as a hobby, you will be subject to self-employment tax in addition to income tax on your activities' earnings.

When you work as a traditional employee, your employer withholds a certain amount of money from every paycheck, which goes to pay employment taxes – 15.3% (12.4% for Social Security and 2.9% for Medicare). Half of that amount is covered by your employer, but running your own business means you are responsible for the full 15.3%, which is called the self-employment tax. You will have to manage the payment of these taxes throughout the year if you expect to pay \$1,000 or more in taxes, which comes in the form of quarterly estimated tax payments. If you do not make these payments, you could be charged penalties and interest for not paying the taxes in a timely manner. For a more detailed discussion on estimated tax payments see the article [here](#).

Despite being subject to self-employment tax, there is still a significant advantage in the fact that you can deduct eligible business expenses if your activity classifies as a business versus a hobby. However, it is important to make sure you legitimize your business in the eyes of the IRS. Part 3 of this series will focus on good business practices that are not only important for every business but help you to classify your activity as a legitimate business for tax purposes.

### **Bottom Line**

If you are dabbling in a quarantine hobby that produces income, be sure you understand the differences between a hobby and a business for tax purposes and the tax-filing consequences of each. While declaring income earned from your hobby may seem like a hassle — especially since you cannot deduct expenses beginning in 2018 — you do not want to get in trouble with the IRS for not reporting all your income. Additionally, if the IRS decides you incorrectly classified your hobby as a business or vice versa, you could face additional taxes, penalties,

and interest.

Please check back the next week for our last article in the series, which will address good business practices for operating and running an online business. And, If you are interested in learning more about the differences between a hobby and a business for tax purposes and how it might affect your tax filing requirements, or how to incorporate or organize a business entity, please contact the author of this article attorney [Britany E. Morrison](#) at O'Neil Cannon to discuss how we are able to assist you.