



2023 Annual Conference Hobby or Business?

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Objectives



- At the end of this course, you will be able to:
 - Identify common types of gig activities
 - Recognize the difference between a trade/business and a hobby

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Gig Activities



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What's a Gig?



- Old gig vs. new gig
 - Old gig – anyone who was paid by the job, not hourly or salary
 - Artists
 - Craftsmen
 - Plumbers, electricians, contractors
 - Aka “side hustle”



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What's the New Gig?



- Temporary worker
- Outside of traditional employer/employee relationship
- Three main components
 - Independent workers paid by the task or project, rather than hourly or salary
 - Consumers who need a specific service
 - Companies that connect the worker to the consumer in a direct manner like apps

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Can You Give Me Some Examples?



- Drivers (Lyft, Uber, etc.)
- Delivery (Grubhub, Doordash, Postmates, Amazon Flex)
- Shopping (Instacart)
- Fiverr, Graphite, Freelancer
- Accommodation (AirBnB, FlipKey, CouchSurfing, Onefinestay)
- Home services (Bellhops, Handy, HomeAdvisor, Porch)
- Etc., etc., etc.



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Hobby? Or Business?



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When It Comes to Gigs...



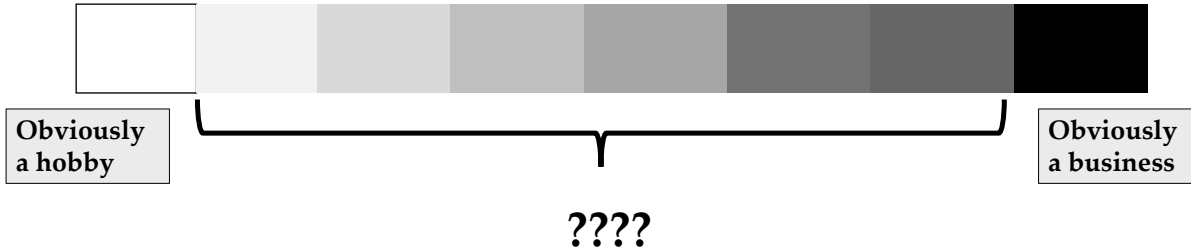
- We've got an important issue!
- If someone is driving for Uber, I think I can be pretty sure it isn't a hobby. But what about income from Etsy?

Hobby**VS.****Business**

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A Lot of Gray Area



IRS' Concern



- “About 1.5 million taxpayers, many with significant income from other sources, filed form 1040 Schedules C showing no profits, only losses, over consecutive Tax Years 2002 – 2005 (4 years); 73 percent of these taxpayers were assisted by tax practitioners. By claiming these losses to reduce their taxable incomes, about 1.2 million of the 1.5 million taxpayers potentially avoided paying \$2.8 billion in taxes in Tax Year 2005.”
- (About \$4.2B in today’s money)

Hobbies per IRS Audit Technique Guide

- Airplane charter
- Artistry
- Auto racing
- Bowling
- Horse breeding
- Horse racing
- Motocross racing
- Photography
- Craft sales
- Direct sales (Avon®, Tupperware® and the like)
- Stamp collecting
- Dog breeding
- Writing
- Entertaining
- Farming
- Fishing
- Yacht charter
- Gambling

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IRC Governing Hobbies §183

- Prior to passage of the TCJA, hobby expenses were deductible only as a Miscellaneous Itemized Deduction on IRS Schedule A.
- This meant they could be deducted only by taxpayers who itemized their personal deductions.
- Hobby expenses were deductible only to the extent they exceeded 2% of the hobbyist's adjusted gross income.
- And such expenses were deductible only up to the amount of hobby income--if you had no income from a hobby, you got no deduction.

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And Then Came TC&JA



- Unfortunately for people who earn income from hobbies, the TCJA completely eliminated the itemized deduction for hobby expenses, along with most other miscellaneous itemized deductions.
- The prohibition on deducting these expenses goes into effect for 2018 and continues through 2025.
- This means that taxpayers are not able to deduct any expenses they earn from hobbies during these years, but they still have to report and pay tax on any income they earn from a hobby!
- The deduction is scheduled to return in 2026.



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IRS Hobby vs. IRS Business



- Business can deduct all expenses, qualify for self-employment health insurance, QBID deduction, IRA contribution
 - But does pay FICA tax
- Hobby has very limited expenses, does not qualify for self-employment health insurance, nor QBID, nor IRA contribution
 - But doesn't pay FICA tax
- Most people would prefer to have a business! But we have to make sure they really do.

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Safe Harbor – Presumption of Business



- Easiest way out of the hobby problem? Make a profit!

§183(d) PRESUMPTION

If the gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting "2" for "3" and "7" for "5".

- Doesn't prove it's a business but shifts the burden of proof to the IRS!

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Safe Harbor – Details



- So that means I can have losses for two years as long as I make money in the 3rd year – got it!
- Not true!
- The safe harbor rule applies beginning with the 3rd profitable year and all subsequent years within a five-year period
- Safe harbor period begins AFTER the third profitable year; then the taxpayer may have two years of losses!

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Safe Harbor – Details



- Example: Jane begins a new activity in Year 1, and incurs losses in Years 1, 3 and 6, and profits in Years 2, 4 and 5
- Year 1: **Loss** of \$5K
- Year 2: **Profit** of \$6K
- Year 3: **Loss** of \$7K
- Year 4: **Profit** of \$6K
- Year 5: **Profit** of \$6K
- Year 6: **Loss** of \$7K
- Safe harbor does not protect losses in Years 1 and 3

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Safe Harbor – Postponing the Presumption



- Jane may elect to delay safe harbor application until close of 4th tax year after the year in which activity begins
 - Losses from the activity are tentatively allowed during the five-year period
 - If application is made and activity is profitable for three or more of the five years, then the activity is presumed engaged in for profit throughout the entire five-year period
 - But if activity is not profitable for at least three years, then the three out of five-year test fails, and taxpayer may face substantial tax liability
 - Election is made with Form 5213, *Election to Postpone Determination as to Whether the Presumption Applies That an Activity Is Engaged in for Profit*

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Form 5213

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Why might filing this form be a bad idea?

5213 Election To Postpone Determination as To Whether the Presumption Applies That an Activity is Engaged in for Profit

OMB No. 1545-0195

Form 5213 (Rev. February 2008)
 Department of the Treasury
 Internal Revenue Service

▶ To be filed by individuals, estates, trusts, partnerships, and S corporations.

Normally, as shown on tax return: _____ Identifying number as shown on tax return: _____

Address (number and street, apt. no., rural route) or P.O. box number if mail is not delivered to street address: _____

City, town or post office, state, and ZIP code: _____

The taxpayer named above elects to postpone a determination as to whether the presumption applies that the activity described below is engaged in for profit. The determination is postponed until the close of:

- The 5th tax year, for an activity that consists mainly of breeding, training, showing, or racing horses or
- The 4th tax year for any other activity,

after the tax year in which the taxpayer first engaged in the activity.

1 Type of taxpayer engaged in the activity (check the box that applies):

Individual Partnership S corporation Estate or trust

2a Part of activity for which you elect to postpone a determination: _____

2b First tax year you engaged in activity described in 2a: _____

Under penalties of perjury, I declare that I have examined this election, including accompanying schedules, and to the best of my knowledge and belief, it is true, correct, and complete.

 (Signature of taxpayer or fiduciary) Date: _____

 (Signature of taxpayer's spouse, if joint return was filed) Date: _____

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IRS and Tax Court Use a 9-Factor Test

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- Those factors are:
 1. The manner in which the taxpayer carried on the activity
 2. The expertise of the taxpayer or his or her advisers
 3. The time and effort expended by the taxpayer in carrying on the activity
 4. The expectation that the assets used in the activity may appreciate in value
 5. The success of the taxpayer in carrying on other similar or dissimilar activities
 6. The taxpayer's history of income or losses with respect to the activity
 7. The amount of occasional profits, if any, which are earned
 8. The financial status of the taxpayer
 9. Elements of personal pleasure or recreation

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Factor #1 – Manner of Engagement



- **(1) *Manner in which the taxpayer carries on the activity.*** The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit.
- Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated.
- A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

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Factor #2 – Expertise



- **(2) *The expertise of the taxpayer or his advisors.*** Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices.
- Where a taxpayer has such preparation or procures such expert advice, but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

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Factor #3 – Time & Effort



- **(3) *The time and effort expended by the taxpayer in carrying on the activity.*** The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit.
- A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit.
- The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

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Factor #4 – Asset Appreciation



- **(4) *Expectation that assets used in activity may appreciate in value.*** The term *profit* encompasses appreciation in the value of assets, such as land, used in the activity.
- Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation.

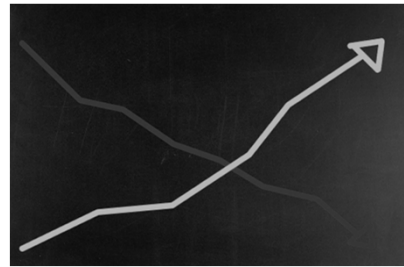
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Factor #5 – History of Success



- **(5) *The success of the taxpayer in carrying on other similar or dissimilar activities.*** The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.



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Factor #6 – History of Gains and Losses



- **(6) *The taxpayer's history of income or losses with respect to the activity.*** A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit.
- However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit.
- If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit.

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Factor #7 – Amount of Profits



- **7) *The amount of occasional profits, if any, which are earned.*** The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent.
- An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit.
- However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small.

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Factor #8 – Financial Status



- **(8) *The financial status of the taxpayer.*** The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit.
- Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.



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Factor #9 – Personal Pleasure



- **(9) Elements of personal pleasure or recreation.** The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved.
- An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit.
- Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

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Nine IRS Tests from Reg 1.183-2



- No one factor predominates!
- You have to look at the whole picture!



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Reg 1.183-2 Example #1



- **EXAMPLE 1.** The taxpayer inherited a farm from her husband in an area which was becoming largely residential, and is now nearly all so.
- The farm had never made a profit before the taxpayer inherited it, and the farm has since had substantial losses in each year.
- The decedent from whom the taxpayer inherited the farm was a stockbroker, and he also left the taxpayer substantial stock holdings which yield large income from dividends.
- The taxpayer lives on an area of the farm which is set aside exclusively for living purposes.
- A farm manager is employed to operate the farm, but modern methods are not used in operating the farm.
- The taxpayer was born and raised on a farm, and expresses a strong preference for living on a farm.
- **The taxpayer's activity of farming, based on all the facts and circumstances, could be found not to be engaged in for profit.**

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Reg 1.183-2 Example #2



- **EXAMPLE 2.** The taxpayer is a wealthy individual who is greatly interested in philosophy. During the past 30 years he has written and published at his own expense several pamphlets, and he has engaged in extensive lecturing activity, advocating and disseminating his ideas.
- He has made a profit from these activities in only occasional years, and the profits in those years were small in relation to the amounts of the losses in all other years.
- The taxpayer has very sizable income from securities (dividends and capital gains) which constitutes the principal source of his livelihood.
- **The activity of lecturing, publishing pamphlets, and disseminating his ideas is not an activity engaged in by the taxpayer for profit.**

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Reg 1.183-2 Example #3



- **EXAMPLE 3.** The taxpayer, very successful in the business of retailing soft drinks, raises dogs and horses.
- He began raising a particular breed of dogs many years ago in the belief that the breed was in danger of declining, and he has raised and sold the dogs in each year since.
- The taxpayer recently began raising and racing thoroughbred horses. The losses from the taxpayer's dog and horse activities have increased in magnitude over the years, and he has not made a profit on these operations during any of the last 15 years.
- The taxpayer generally sells the dogs only to friends, does not advertise the dogs for sale, and shows the dogs only infrequently.

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Reg 1.183-2 Example #3 (Cont.)



- The taxpayer races his horses only at the “prestige” tracks at which he combines his racing activities with social and recreational activities.
- The horse and dog operations are conducted at a large residential property on which the taxpayer also lives, which includes substantial living quarters and attractive recreational facilities for the taxpayer and his family.
- Since (i) the activity of raising dogs and horses and racing the horses is of a sporting and recreational nature, (ii) the taxpayer has substantial income from his business activities of retailing soft drinks, (iii) the horse and dog operations are not conducted in a businesslike manner, and (iv) such operations have a continuous record of losses, **it could be determined that the horse and dog activities of the taxpayer are not engaged in for profit.**



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Reg 1.183-2 Example #4



- The taxpayer inherited a farm of 65 acres from his parents when they died 6 years ago.
- The taxpayer moved to the farm from his house in a small nearby town, and he operates it in the same manner as his parents operated the farm before they died.
- The taxpayer is employed as a skilled machine operator in a nearby factory, for which he is paid approximately \$8,500 per year.
- The farm has not been profitable for the past 15 years because of rising costs of operating farms in general, and because of the decline in the price of the produce of this farm in particular.
- The taxpayer consults the local agent of the State agricultural service from time to time, and the suggestions of the agent have generally been followed.

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Reg 1.183-2 Example #4 (Cont.)



- The manner in which the farm is operated by the taxpayer is substantially similar to the manner in which farms of similar size, and which grow similar crops in the area, are operated.
- Many of these other farms do not make profits.
- The taxpayer does much of the required labor around the farm himself, such as fixing fences, planting crops, etc.
- **The activity of farming could be found, based on all the facts and circumstances, to be engaged in by the taxpayer for profit.**



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QUIZ

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Arizona
Chapter 35^{Years}

- Which of the following is **not** one of the factors that determine a hobby?
 1. The manner in which the taxpayer carried on the activity
 2. The age of the taxpayer
 3. The time and effort expended by the taxpayer in carrying on the activity
 4. The expectation that assets used in the activity may appreciate in value
 5. The taxpayer's history of income or loss with respect to the activity
 6. The financial status of the taxpayer, and
 7. Elements of personal pleasure, satisfaction or recreation

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Special Circumstances

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Dana's Guest House

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- Dana rents out a guest house on her property
- • Guests typically stay 2-3 days.
- • She provides maid service and breakfast.
 - She has complete records of income and expenses.
 - This is the only money-making activity she engages in.



Is this a gig, a rental, or a business??

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Dan the Insurance Man

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- Dan has a 1099-NEC reporting \$15,000 of income in Box 1.
- He is a retired insurance agent.

Is this Schedule C income or Schedule 1 income?



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Dan the Insurance Man



- **(k) CODIFICATION OF TREATMENT OF CERTAIN TERMINATION PAYMENTS RECEIVED BY FORMER INSURANCE SALESMEN**
- Nothing in subsection (a) [NET EARNINGS FROM SELF-EMPLOYMENT] shall be construed as including in the net earnings from self-employment of an individual any amount received during the taxable year from an insurance company on account of services performed by such individual as an insurance salesman for such company if—

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Dan the Insurance Man



- **(1)** such amount is received **after termination** of such individual's agreement to perform such services for such company,
- **(2)** such individual **performs no services** for such company after such termination and before the close of such taxable year,
- **(3)** such individual enters into a **covenant not to compete** against such company which applies to at least the 1-year period beginning on the date of such termination, and
- **(4)** the amount of such payment—
 - **(A)** depends primarily on policies sold by or credited to the account of such individual during the last year of such agreement or the extent to which such policies remain in force for some period after such termination, or both, and
 - **(B)** does not depend to any extent on length of service or overall earnings from services performed for such company (without regard to whether eligibility for payment depends on length of service).

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Elena's Royalties

- Elena wrote a book about her struggles in adjusting to life in a wheelchair.

<input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED		OMB No. 1545-0115		Miscellaneous Information
PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Rents	Form 1099-MISC	
PAYER'S TIN		2 Dividends	(Rev. January 2022)	
RECIPIENT'S TIN		3 Other income	For calendar year 20	
RECIPIENT'S name		4 Federal income tax withheld		
Street address (including apt. no.)		5 Fishing boat proceeds		
City or town, state or province, country, and ZIP or foreign postal code		6 Medical and health care payments		
13 FATCA filing requirement <input type="checkbox"/>		7 Payer made direct sales totaling \$5,000 or more of consumer products to recipient for resale <input type="checkbox"/>	8 Substitute payments in lieu of dividends or interest	
Account number (see instructions)		9 Crop insurance proceeds	10 Gross proceeds paid to an attorney	
		11 Fish purchased for resale	12 Section 403A deferrals	
		14 Excess golden parachute payments	15 Nonqualified deferred compensation	
		16 State tax withheld	17 State-Payer's state no.	18 State income

Form **1099-MISC** (Rev. 1-2022) www.irs.gov/Form1099MISC Department of the Treasury - Internal Revenue Service



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Elena's Royalties

- Where do we report this?
- It depends
 - Schedule E if taxpayer is not otherwise engaged in the trade of writing
 - E.g., book was written years ago, and author is not currently writing
 - Schedule C if taxpayer is actively engaged in the trade of writing
 - Schedule E = passive, Schedule C = active!



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Elena's Royalties

- Turns out Elena has signed a contract to write a sequel.
- Since Elena is active in the business and will file a Schedule C, she can report expenses. Typically:
 - Research materials
 - Any special software
 - Office supplies, printing costs
 - Possibly office in home
 - Legal and professional fees (editors, agents, tax prep, etc.)
 - Travel
 - Memberships



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Case Studies



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Case Study – Edward



- Eva is a highly paid executive; Edward has an art gig
- Edward makes and sells custom frames, also collects and sells art out of a large studio
 - Expectation is that the art will appreciate!
 - Owns the studio – mortgage interest, taxes, insurance, utilities, security, etc.
 - The art gig loses money for TEN CONSECUTIVE YEARS



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My “Interview” Sheet



1. **Manner:** there are books and records, a separate bank account, a separate credit card. There's a bookkeeper, but Edward has never really looked at her reports.
2. **Expertise:** Edward has been in the art world all his life, and he is a patron and sole distributor of a particular artist that he admires, whose work he thinks will appreciate.
3. **Time/effort:** This is Edward's full-time job, he doesn't do anything else with his time, and he's there every day. He has a website, he holds events for people to come and look at the art. He and his artist travel around a bit, trying to get the artist some visibility.
4. **Asset appreciation:** That's definitely the expectation. Not just the art, but the commercial building as well!
5. **Success with similar efforts:** Edward says he has purchased and sold art for years, though he's never made a profit on it.
6. **History of gains/losses:** Losses every year
7. **Amount of profits:** None
8. **Financial status:** They live pretty well, in a pricey gated community. Eva's highly paid job supports Edward's endeavor. Basically, he couldn't do this if she wasn't making serious six figures.
9. **Personal satisfaction:** Art is Edward's passion.

Your thoughts?

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Case Study – Phyllis



- Phil has a highly paid W-2 job, Phyllis is a “life coach”
 - Year 1, life coach gig grosses \$500 and has \$15,000 in expenses
 - Most of the expense is taking classes
 - Year 2, life coach gig grosses \$750 and has \$8,500 in expenses
 - Most of the expense is taking classes.
 - There is no “official minimum training” requirement for this type of coaching and her school’s website claims that attendees can deduct all classes.



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Case Study – Phyllis



1. **Manner:** there’s no bookkeeper. Phyllis uses her personal bank account for the business.
2. **Expertise:** Phyllis has spent all of year 1 and most of Year 2 taking classes, and she’s done really well in the classes. Her teachers have commended her for being a natural coach and devoting so much time and energy to her classes. She took a few classes in psychology in college, but that wasn’t her major.
3. **Time and effort:** she doesn’t have any other occupation and devotes about 20-30 hours per week to classes, reading, etc.
4. **Asset appreciation:** there are no assets.
5. **Success with similar efforts:** she’s had several W-2 jobs since college, but hasn’t worked since the kids were born. No similar activities in the past.
6. **History of gains and losses:** well, it’s all losses so far, but she has several friends who have taken the same classes and are making money, and she’s sure she will as well.
7. **Amount of profits:** none.
8. **Financial status:** Phil is supporting them in an upper middle-class lifestyle.
9. **Personal satisfaction:** she gets a great deal of personal satisfaction from this work, though she wouldn’t call it fun.

Your thoughts?

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It's a Hobby – Now What?



- Report hobby income as other income on Schedule 1 (Form 1040), Part I, not subject to SE tax
- Subtract any COGS on Schedule 1, Part II.
- A taxpayer engaged in a hobby:
 - Can't contribute to retirement plans based on this income
 - Can't take a loss to offset other income
 - Can't deduct office in home
 - Isn't eligible for QBID
 - Isn't eligible for the self-employed health insurance deduction
 - (But doesn't pay self-employment tax on earnings)


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One Thing to Note...



- If the income reported on Schedule 1 is high, the IRS may question that it's really a hobby! (Because maybe the taxpayer is just trying to get out of paying FICA tax!)

 **IRS** Department of the Treasury
Internal Revenue Service
Ogden Service Center
OGDEN UT 84201-0034

The income amount of \$47,668.00 you reported on line 9 of Schedule 1 indicates you may be liable for self-employment tax. This tax applies when Social Security and Medicare taxes are not withheld from your earnings. For example, if you received cash for services performed or Form 1099-MISC or Form 1099-NEC for non-employee compensation and the payer didn't withhold Social Security and Medicare taxes from your income, your earnings may be subject to self-employment tax.

If you're not liable for self-employment tax, provide an explanation with your reply to this letter.

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Questions?

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