



Tax Facts – Business Versus Hobby?

Albert makes (and sells) wooden toys from his home. He is running a business. Jill also makes (and sells) wooden toys from her home - but she does it as a hobby. This article explains the approach used by Inland Revenue (and the courts) when they are deciding if an activity is a business or a hobby.

It's important to be able to tell the difference. If you're running a business, your income is taxable and your business expenses are deductible. But if it's a hobby, you don't pay tax on your income and your expenses are not deductible. The "business or hobby" issue can be complex. This article gives you general information only. Each case must be decided on the facts, so if you have any questions about your own situation, please contact your tax advisor or Inland Revenue.

What is a business?

The law says that a business: "includes any profession, trade, manufacture, or undertaking carried on for pecuniary profit..."

The courts have held that a person is probably running a business if:

1. the activity is carried out in an organised and coherent way, and
2. the person is intending to make a profit.

Note that "intending to make a profit" doesn't mean you must make a profit - an activity can make a loss and still be a business - but the intention must be there. Establishing intention involves considering the person's words and conduct.

What is a hobby?

A hobby is an activity conducted primarily for private pleasure or recreation. The hobbyist is not interested in making a profit. They may sell goods, but any sales are of secondary importance.

Business or hobby?

Deciding whether an activity is a business or a hobby is one of the "grey areas" of tax law. The table below shows some of the areas Inland Revenue and the courts consider and it gives you an idea of the decision-making process.

<u>Areas to consider</u>	<u>Signs which may indicate a business</u>	<u>Signs which may indicate a hobby</u>
The scale of operations?	Relatively large. The activity can involve substantial stock, equipment and staff.	Relatively small.
The volume of transactions?	Many transactions with customers.	Only a few transactions and casual sales.
The commitment of time, money and effort?	A major time commitment. Significant investment of money. Much effort dedicated to the activity.	A part-time activity. Minor investment of money. The activity is conducted when time permits.
The pattern of activity?	Regular.	Now and again.
The financial results?	Significant dollar values. Profits are usually achieved. But occasional losses may occur. If losses occur, a business will usually make changes to try to achieve a profit.	Small dollar values. Often losses are made. (Making a profit is not important.)
The type of activity?	A profession, trade, manufacture, or undertaking. The taxpayer often depends on the income for their livelihood.	The activity is conducted primarily for private pleasure or recreation. The taxpayer does not usually depend on the income for their livelihood.
Does the activity have to comply with regulations?	The activity may have to comply with government or local body regulations (eg health and safety requirements).	The activity won't usually have to comply.
Are operations in line with the usual practices for the industry?	Yes. And there is usually evidence of a "business-like" approach to the activity. For example the taxpayer may: " get a feasibility study done " prepare budgets " develop a marketing plan " run an accounting system " keep records.	No. And there is usually an "informal" approach to the activity.
What is your intention behind performing the activity?	A comment like: "My goal is to make a profit."	A comment like: "I do the activity as a recreational pursuit, not to make a profit." (The essential test as to whether a business exists is the intention of the person as evidenced by their conduct.)

Please note:

The table is a general guide only. Each situation must be considered on its own merits. For example, the table suggests that to be a business, the activity must be "relatively large". While it is true a business tends to be on a bigger scale than a hobby, a small activity can also be a business.

Again, if you have any questions about your own activity, we recommend you contact Inland Revenue, or talk to your tax advisor.

Here are two examples of the "business v hobby" decision, taken from actual court cases.

Example 1

A husband and wife partnership purchased a run-down farming property of 216 acres. Over the years they developed the property by clearing it of gorse and refencing it. A Hereford stud herd of a modest size was established. The farming activity made losses over the years 1972 - 1980. The husband and wife, in their income tax returns, each deducted their share of the losses from their other income.

The Court of Appeal found that the farming activity was a business, despite the ongoing losses. This was because:

- the partnership carried out the activity for a number of years
- the land area was big enough to support a viable business
- the partners put a lot of time, energy and money into the activity
- the activities were in line with usual farming practices
- the development work was organised and systematic
- the partnership kept proper accounts.

Example 2

A dentist owned a launch. He used the launch privately, but also conducted a launch charter activity - which made a loss. The High Court found that the charter activity was not a business for these reasons:

the dentist didn't fully investigate the feasibility of the activity before he bought the launch
 there were no serious attempts to market the activity
 over the year there were three charter trips and 21 private trips - this suggested that launch was bought primarily for private use
 the activity never looked like a serious money-making venture
 the launch was not readily available for chartering
 the year after the dentist made the loss, he kept the launch for his own private use.

Developing a business from a hobby

Do you enjoy your hobby so much that you'd like to earn your living at it? Some home businesses did originally start out as hobbies. If you want to develop a business from a hobby, the important thing to remember is expenses you incur prior to starting your business are usually regarded as capital expenses and are non-deductible for income tax purposes.

In most cases your business will "officially" start when:

- you buy or sell stock, or
- you start performing your services for your customers, and
- both of these activities are at a significant, profit-motivated level.

Example 3

Anne makes teddy bears from home. In any given year she usually makes about 10 bears, keeps one or two for herself and gives the rest to family and friends. Sometimes people pay money to Anne to cover her costs and sometimes they don't.

At this stage, Anne's teddy bear activity is a hobby.

Because her bears are so popular with her friends, she decides to have a go at profiting from the activity. She takes the following steps.

1. She approaches a number of retailers to see if they will stock her bears in their shops. Some shops are willing and Anne enters into contracts with them.
2. She buys a special sewing machine which will speed up the production process.
3. She buys a computer and fax which she will use to manage orders and sales.
4. She travels to Auckland to attend a basic bookkeeping course.
5. She buys stationery including invoice books and receipts.
6. She buys a bulk order of fur, leather and other materials. She starts work on her first production run.

7. She sells her first batch of bears to Bears Incorporated, a shop in town.

Because Anne has changed the way she is running the teddy bear activity - it is now organised with an intention to make a profit - the activity has changed from a hobby to a business.

If you are in this situation, please seek further advice from your tax advisor or Inland Revenue.

What about the GST aspect?

For income tax purposes your income is taxable and your expenses are deductible if you are running a business.

For GST purposes, you pay GST on your sales and claim GST on supplies consumed in the course of your taxable activity, if you are registered for GST.

A taxable activity is an activity which is:

- carried on continuously or regularly, and
- involves (or is intended to involve) the supply of goods and services to any other person for a consideration.

A hobby is not a taxable activity. Most businesses are taxable activities. However, some taxable activities are not businesses. That's because you can carry on a taxable activity even if you're not intending to make a profit. Some schools and charities run taxable activities.

You must register for GST if you are conducting a taxable activity and your annual turnover exceeds \$60,000. If your annual turnover is \$60,000 or below you can register for GST, but you don't have to.

A useful guide is GST - do you need to register? (IR 365).

Note you can register for GST online.

Again, please note:

This explanation of taxable activities is a general guide only. If you have any questions about your own activity, we recommend you contact Inland Revenue, or talk to your tax advisor.