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Farm Losses versus Hobby Losses: Farmers Must Plan Ahead to Avoid Adverse Tax Consequences*

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Introduction

The hobby loss rules which determine whether a venture is a business or a hobby, is a frequently misunderstood area of tax law that causes producers who are experiencing difficult economic times to worry, perhaps unnecessarily, that the venture will be viewed as a hobby rather than a true business venture. This article is intended to provide information to help producers reduce the likelihood that the business venture will be deemed a hobby.

IRS Definition of a Hobby

In order to deduct expenses in *excess* of income for a given venture, the taxpayer must be engaged in that venture for profit. *Profit* is defined as income (receipts) greater than expenses, where expenses include depreciation of capital assets. The rules covering hobby losses provide an objective standard to determine whether a taxpayer has a legitimate business operation. The law presumes that an activity is not a hobby if profits occur in any three of five consecutive years or two of seven consecutive years for equine activities. The failure to meet the profit test does not automatically make the activity a hobby; it only allows the IRS to look deeper into the venture. If the IRS can prove that the operator has no intent to make a profit or is attempting to generate tax losses to offset other taxable income, the activity is then assumed to be a hobby and all deductions in excess of income are disallowed.

The "hobby loss" profitability test of three out of five years (or two out of seven for horse breeders) does not solely determine whether a business will be considered a hobby by the IRS. This test only *allows* the IRS to look at the business in greater detail. Until the test of failing to show a profit for the stated number of years is met, the IRS cannot question the profit motive. Once the business has failed to show a profit in three out of five years (or

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two out of seven years for horse breeders), the IRS is permitted (but not required) to examine the business. Therefore it is important for the operator of an activity that is just getting started to do a good job of managing both business and income taxes to reduce the risk of being examined by the IRS.

Nine Factor Guidelines

The IRS's actual determination of whether a business has been operated with a profit motive is based on all facts and circumstances about the business operation provided by the producer. IRS regulations use nine factors as guidelines to make this determination. No single factor or group of factors will determine the outcome. It is a subjective judgment call where all facts are taken into account. However, the producer can reduce the odds of the venture being treated as a hobby by becoming aware of these nine factors and using them as guidelines for operating the business in a businesslike manner. Most importantly, the producer can further be protected by keeping good records.

1. **Is the activity carried on in a businesslike manner?** If the producer keeps businesslike books and records, changes methods of operation that are not working, tries to use profit-making techniques to increase efficiency and profitability, or even abandons a business venture that is going nowhere, the profit motive may be indicated. Is there a business plan? Does the producer have a separate bank account for activity?

2. **What is the expertise of the producer or his or her advisors?** The producer should be able to show that he or she has studied the accepted practices of the venture engaged in and/or has sought advice from experts in the field. In other words, the producer has read books, taken classes, paid advisors, and taken their advice. If the producer has gotten advice and information and has operated in a completely different manner, he or she should be prepared to show that an attempt has been made to develop new practices which could result in profit.

3. **How much time and effort are being expended by the producer in this business?** If the producer is spending significant personal time and effort on the activity, it can indicate a profit motive. Employing competent persons to run the activity for the producer may also indicate a profit motive.

4. **Are the assets expected to appreciate in value?** Overall profit could be reasonably expected from an increase in business assets such as land value, livestock, or other assets. This can be true even if operations of the business are not showing a current profit. Does the income generated from the activity cover the variable costs of carrying the assets?

5. **Has the producer done this before?** Has the producer been successful in carrying on similar activities for a profit? If the producer has carried on similar activities in the past and turned them from unprofitable to profitable, a profit motive could be assumed.

6. **What's been happening here?** What is the history of income or loss? Are losses mainly a start-up situation or have they been sustained beyond a reasonable length of time? If there have been unforeseen circumstances beyond the producer's control—such as drought, flood, fire, theft, war, depressed market conditions, etc.—the reasonable length of time for loss could be extended. Again, good records would help support this type of claim.

7. **Has the producer made <u>any</u> money?** What profits, if any, have been earned? The occasional small

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profit from a venture offset by persistent high losses would probably indicate that there is no profit motive. A solid profit, though infrequent, or a reasonable opportunity to achieve an eventual profit might support the producer's profit motive.

8. **Is the producer making money doing anything else?** What is the financial status of the producer? If there is no substantial income from other sources, it is a good bet the activity is meant to generate a profit. Substantial income from other sources may suggest the producer can "afford to support the hobby." However, the presence of other income, especially during the start-up period of a venture, shows good planning and would not negate the profit motive.

9. **Is the producer having fun?** The presence of personal pleasure or recreation in an activity has often been used by the IRS to claim an activity as a hobby. However, the other factors mentioned in this article are also taken into consideration by the courts. The fact that a person enjoys a business is not sufficient to disallow the profit-making motive.

Keep a written record of everything done to improve the producer's business management skills. If the producer has taken a class related to the business, consulted with an accountant or business expert, or bought a book, the receipts must be kept as documentation. If the producer has taken advice and changed a method of operations to improve efficiency, write it down. If there has been a flood, drought, or disease in the area that affected business profits, write it down, cut out the news articles, and keep records. Record the hours spent in the activity, record the business mileage, keep receipts, and hope that a profit is made next year.

IRS Publications

For a further discussion of hobby farm losses, see IRS Publication "Farmers Audit Tax Guide," July 2011, available at: https://www.irs.gov/businesses/small-businesses-self-employed/farmers-atg

I.R.C. Section 183: "Activities Not Engaged in For Profit (ATG)," June 2009 available at:
https://www.irs.gov/businesses/small-businesses-self-employed/irc-183-activities-not-engaged-in-for-profit-atg

Additional Topics

This fact sheet was written as part of Rural Tax Education, a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets, and additional information related to agricultural income tax, please see RuralTax.org.

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