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Farm Losses or Hobby Losses: Farmers and Business Owners Must Plan Ahead

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Hobby loss is an often misunderstood area of taxation, causing worry to the taxpayer involved in a business. Congress sets rules which state that in order to deduct expenses in *excess* of income for a given venture, you must be engaged in that venture for profit. *Profit* is defined as income greater than expenses, where expenses include depreciation of capital assets. The rules on hobby loss provide an objective standard to determine whether a taxpayer has a legitimate business operation or is attempting to generate tax losses to offset other income. If there is no intent to make a profit, the IRS assumes the activity is a hobby and will disallow deductions in excess of income. The general test to measure profit motive is whether the activity has generated a profit in any three out of five consecutive tax years. If the activity deals with breeding, training, showing, or racing horses, the test is any two out of seven years. While many taxpayers are aware of this general test, it is usually as much information as the average taxpayer knows. For the struggling business owner whose business venture is not showing a profit, it is often a concern that the IRS will follow the general test and disallow all deductions. However, there is more information available to help the taxpayer in this situation.

The "hobby loss" profitability test of three out of five years (or two out of seven for horse breeders) does not determine whether a business will be considered a hobby by the IRS. This test only *allows* the IRS to look at the business in more 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 two out of seven years for horse breeders), the IRS can look at the business. This does not automatically mean they will, only that they can. In addition, the test does not automatically determine whether a business should be considered a hobby, but rather that the IRS can examine it in more detail.

The actual decision of whether a business has been operated with a profit motive is based on all facts and circumstances. There are nine factors set forth in the IRS regulations to be used as guidelines — no one factor or group of factors will determine the outcome. It is a subjective judgment call where all facts are taken into account. However, the taxpayer can protect himself or herself by being aware of these nine factors and using them as guidelines. Most importantly, the taxpayer can further be protected by keeping good records.

(1) **If it looks like a duck and sounds like a duck, it is a duck.** Is the activity carried on in a businesslike manner? If the taxpayer keeps businesslike books and records, changes methods of operation that are not working, tries to use techniques of profit-making ventures to increase efficiency and profitability, or even abandons a business venture that is going nowhere, the profit motive may be indicated.

(2) **Can you take advice?** What is the expertise of the taxpayer or his or her advisors? The taxpayer 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, he or she has read books, taken classes, paid advisors, and taken their advice. If the taxpayer 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) **Are you spending time here?** How much time and effort are being expended by the taxpayer in

this business? If the taxpayer 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 taxpayer may also indicate a profit motive.

(4) **Is anything here worth money?** Are the assets expected to appreciate? Overall profit could be reasonably expected from an increase in land value, cattle, or other assets, even if operations of the business are not showing a current profit.

(5) **Have you done this before?** Has the taxpayer been successful in carrying on similar activities for a profit? If the taxpayer 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 taxpayer's control, such as drought, 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) **Have you made <u>any</u> money?** What profits, if any, have been earned? The occasional small profit from a venture offset by persistent high losses would probably indicate there is no profit motive. A solid profit, though infrequent, or a reasonable opportunity to achieve an eventual profit might support the taxpayer's profit motive.

(8) **Are you making money doing anything else?** What is the financial status of the taxpayer? If there is no substantial income from other sources, it is a good bet the activity is meant to generate a profit. 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) **Are you 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.

If you have taken a class related to your business, consulted with an accountant or business expert, or bought a book, keep the receipts. If you have 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 affecting your business profits, write it down, cut out the news articles, keep records. Record your hours, record your mileage, keep your receipts, and hope you make a profit next year.

This information is provided to educate taxpayers about the income tax consequences of hobby losses. If you need more specific information, or feel your farm or business operation is in danger of being declared a hobby by the IRS, contact your Area or State Extension Economist. Your County Extension Office can get you in touch with either of these people. In addition, you may want to contact your income tax preparer.

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