Farm Losses versus Hobby Losses: How to Avoid Adverse Tax Consequences*

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Introduction

The Internal Revenue Service refers to hobbies as "activities not engaged in for profit". The hobby loss rules are used to determine whether a venture or activity is a business or a hobby. This is a frequently misunderstood area of the tax law that causes producers who are experiencing difficult economic times to worry, perhaps unnecessarily, that their farm business 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.

Definition of a Hobby

When filing an income tax return, it is important to determine if a venture is a business or hobby. Unfortunately, the IRS does not provide a clear definition. In some cases, it may be obvious that a taxpayer engages in an activity for sport or recreation, which would be defined as a hobby. In general, the IRS considers an activity a trade or business, and not a hobby, if it is conducted with a profit motive. Profit is defined as income (receipts) greater than expenses, where expenses include depreciation of capital assets. Note that this determination does not require that a profit is generated, only that there is motive for profit in conducting the activity.

The distinction between a hobby and a trade or business is important because it determines the deductibility of expenses related to the activity. Prior to the Tax Cuts and Jobs Act (TCJA), which

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went into effect for the 2018 tax year, a taxpayer who received income from a hobby was able to deduct expenses related to that hobby (up the amount of income received) as a Miscellaneous Itemized Deduction on Schedule A of their individual income tax return. TCJA eliminated most Miscellaneous itemized deductions, and with it the ability to deduct hobby expenses while still requiring taxpayers to report income from the hobby.

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 are disallowed.

For a business activity that is just getting started and has not had a profit for three (or two) years, the operator can elect to postpone the IRS determination that the activity is not carried on for a profit until it has been carried on for 5 (or 7) years. This provides a longer period of time for the business to become established before the IRS can question whether or not the activity is engaged in for-profit. (This election is made by filing Form 5213 which provides for an automatic extension of the examination period.) 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 potential risk of being examined by the IRS.

Nine Factors Used as Guidelines

The IRS's actual determination of whether a business is being operated with a profit motive is based on all facts and circumstances about the business operation provided by the producer. IRS regulations provide nine factors used 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 detailed business 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? Is the business bank account only used for business purposes?

2. What is the expertise of the producer and 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 received 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 making a 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 business 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 IRS may postpone making the determination until a later year. Again, good records are needed to help support this type of claim.

7. Has the producer made any money? What profits, if any, have been earned? The occasional small profit from a venture offset by persistent large losses could likely indicate that a profit motive does not exist. 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 venture as a 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 tax court. The fact that a person enjoys working in a business is not sufficient to disallow the profit-making motive.

It is also important to 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 to help improve the business, the receipts must be kept as documentation. If the producer has taken advice and changed a method of operation 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 addition information concerning hobby losses and making sure your venture is viewed by IRS as a business refer to the following publications.

- IRS Publication 225, Farmer's Tax Guide
- IRS Publication 17, Your Federal Income Tax
- IRS Publication 525, Taxable and Non-Taxable Income
- IRS Publication 535, Business Expenses

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.