AGRICULTURAL FINANCIAL AND TAX PLANNING

BUSINESS OR HOBBY LOSS? Part 1

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When we first started writing articles about the Hobby Loss issues raised by the IRS, we were under the Obama Administration. Now, since Trump has become president, we will look for the enforcement to be strengthened by reason of capitalization and free enterprise, but we still must be aware of the hobby loss rules and regulations.. I would like to expand our discussion on the issue and review how the IRS is currently interpreting Hobby Loss rules and regulations. This article will focus on part-time ranchers and farmers along with full-time farmers who are expanding their operation into other areas of agricultural business, such as a cattle rancher starting a blueberry farm, sod operation or deer farm. A hobby is an activity not engaged in for a profit and Hobby Losses can only be deducted to the extent of hobby income received. Conversely, losses generated by an activity intended to make a profit can offset other income such as wages, salaries or income from other operations.

The General Presumption

As defined by the IRS, “IRC 183(d) [Hobby Loss rules] provides a general presumption test that an activity is engaged in for a profit if the activity has a profitable for 3 years of a consecutive 5 year period or 2 years of a consecutive 7 year period for activities that consist of breeding, showing, training or racing horses.” This presumption test also applies to cattle operations and the development of other animals..

If the taxpayer meets the presumption test, the IRS still has the ability to take the position that the taxpayer’s activity is not a for-profit business. The burden of proof that the activity is not engaged in for a profit falls on the IRS, not the taxpayer. If a taxpayer does not meet the presumption test, he or she can override the presumption that the activity is not a for-profit activity with other facts and information. Additionally, the IRS cannot use the failure of a taxpayer to meet the presumption test as the sole basis for disallowing losses under IRC Section 183. The IRS can also choose not to continue the examination if the taxpayer meets the presumption.

<u>Relevant Factors</u>

If the taxpayer does not meet the presumption tests or the IRS argues that the activity is not a for-profit business regardless of the presumption test, then the IRS will look to the 9 relevant factors to make their determination. This article covers the first 4 factors; Part 2 will be in the July issue and will discuss the next 5 factors and provide a detailed summation.

1. **<u>The manner in which the taxpayer carries on the activity</u>**
   A taxpayer that carries on an activity in a businesslike manner, maintains complete and accurate books and records, has a **separate bank account for the activity**, and has a business plan, may indicate the activity is engaged in for a profit. If you are operating more than one activity, separate books and records and a separate bank account must be maintained for each separate activity. Supporting documents must be kept.
   The taxpayer must know their business plan along with **knowing their business** inside and out when questioned by an IRS examiner. Knowing details about your business and being able to answer questions without referring to notes presents a stronger case that it is a for-profit activity.
   Changing operating methods, introducing new techniques and discontinuing unprofitable methods in your operations to improve efficiency and profits indicates a for-profit activity. Use your books and records to make informed decisions and changes that will aid in operating a profitable business.
   A written business plan is preferable, but being familiar with your plan and knowing the details is most important. **Know your business!**
   Conducting your activity in a manner similar to other activities of the same nature that are profitable indicates a profit motive.

2. **<u>The expertise of the taxpayer or their advisors</u>**
   Preparation and extensive study of the accepted business, economic and scientific practices of the activity must be done by the taxpayer and/or they

should consulting with expert professionals, who know the farming/cattle industry., In order to indicate a for profit motive a business must carry on the activity in accordance with those practices.. You will need a tax and financial professional as well as a technical expert, such as a nutritionist, IFAS county agent, veterinarian or product/crop/breed specialist in the activity. These professionals/consultants can assist you in preparing your business plan but you must also meet with them on a regular basis. We advise meeting with your tax advisor at least quarterly and once a year with your technical expert. Always make sure to document the meeting, what issues were discussed and how the items or points discussed improved the operation and profitability of your activity. Taxpayers, with the help of their technical expert, should devise new ways to more efficiently operate their business in order to improve profits.

3. **Time and effort expanded by the taxpayer in carrying on the activity**
The taxpayer must devote as much time as necessary to operate the activity in a business manner. Personal pleasure or entertainment must be kept to a minimum. For this factor, the time spent must be devoted to operating the activity as a business. The taxpayer can employ competent and qualified persons to carry on the operations of the business but must also remain active in the operation to avoid the Passive Activity rules. As stated above, the taxpayer must know important details within their business.
It is very important that the taxpayer keep a detailed and accurate log of his or her participation in the activity. The taxpayer should document in detail what he/she does while participating in the activity. This log should be kept on an ongoing basis. If you are involved in an audit, a log prepared after the fact provides a much weaker defense in proving the activity is being operated for a profit. The lack of time devoted to the operation gives the auditor an alternative position to disallow the deduction.

4. **Expectation that assets used in activity may appreciate in value**
This factor is extremely significant. The IRS gives as equal weight to this factor as they do to the first three factors combined. Basically, to meet this factor, the taxpayer must intend to derive a profit from the operation of the activity including the appreciation in the value of all invested assets. This factor may prove more difficult for a taxpayer that is **growing** a business. A rancher who is starting a herd will have a longer period of time before he or

she has a marketable product, compared to a taxpayer that is **going into** business and buys an existing herd. The rancher growing a business may need less starting capital but will have a longer start-up period. The rancher going into business will have a shorter start-up period but will require a larger initial investment. The rancher going into business will have a better chance of not only satisfying this factor, but also satisfying the presumption test.

Another issue of concern is whether or not the unrealized appreciation of land value can be used by the taxpayer in satisfying factor Number 4. For instance, a taxpayer who starts a cattle raising business may allocate a portion of his existing land to the new business thinking the appreciation in the land can be used to meet this factor. The IRS may take the position that the holding of the land is a separate activity and thus future land appreciation cannot be used to meet the factor. In many cases, excluding the land will make this factor difficult to satisfy. The courts have differed on the application of this factor. Some have allowed the unrealized appreciation of land in determining the taxpayer's ability to satisfy this factor, some have not. Since the taxpayer **may not prevail** on this factor, he or she must be very strong on the first 3 factors.

Due to the amount of information that we would like to provide on this topic, the article will be continued in the July 2017 issue of the Cattleman Journal as Part 2. We will discuss the other 5 factors plus a summation.

For more information on this topic and other tax planning for agricultural operations, please contact me at my cell (863) 640-2008 or Tom@beasleybryantcpa.com and/or Ryan Beasley at (863) 646-1373 or Ryan@beasleybryantcpa.com . Please visit our website at www.beasleybryantcpa.com for information on other relevant topics.

We at Beasley, Bryant & Company, CPA's, P. A. are experienced in agricultural business problems, tax issues or concerns, and are here to help you.

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