AGRICULTURAL
FINANCIAL AND TAX PLANNING

BUSINESS OR HOBBY LOSS?
Part 2

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This is the second of two articles regarding the business vs. hobby loss activity. Last month we discussed the IRS's "general presumption rule", and we also discussed the use of the nine relevant factors if the general presumption rule does not satisfy the IRS or the taxpayer. In the previous article, we also reviewed the first four factors:

1. The manner in which the taxpayer carries on the activity.
2. The expertise of the taxpayer or their advisors.
3. Time and effort expended by the taxpayer in carrying on the activity.
4. Expectation that assets used in the activity may appreciate in value.

We also stated that the IRS has a tendency to give as much weight to the fourth factor as they do to the first three combined. This is an important consideration for taxpayers when they are attempting to defend their activity as a business as oppose to a hobby. This article will cover the last five relevant hobby loss activity factors and give a detailed summation of the issues surrounding these factors.

Relevant Factors continued

5. **The success of the taxpayer in carrying on other similar or dissimilar activities**

The fact that the taxpayer has engaged in similar or other activities in the past and has successfully operated those businesses or converted unprofitable operations to profitable businesses, may indicate the taxpayer is engaged in the present activity for profit, such as a capitalist. Success in any type of business should meet this factor. The ability to make managerial decisions or having someone working with or for the taxpayer possessing managerial skills will also help meet this factor.

The examiner will focus on the activity in question as well as other activities the taxpayer is involved in or has been involved in including the taxpayer's primary source of income. For example, if the taxpayer is a medical doctor, the examiner will focus on unrelated activities the doctor is currently operating or has operated in the past such as a cattle ranch or restaurant. The examiner will also look at the doctor's primary source of income andif he or she is self-employed. Unsuccessful or abandoned past activities may be hard to overcome in supporting a taxpayer's current activity as a for profit operation. On the other hand, this factor may be neutral if the taxpayer has not engaged in activities other than their primary source of income in the past or that has operated both successful and unsuccessful past businesses. In most cases, this factor can be won by the taxpayer.

6. **The taxpayer's history of income or losses with respect to the activity**

Losses during the first several years (start-up years) may not negate the presumption of a profit motive. However, losses that continue after the normal start-up period for the activity and are not due to customary business risks or reverses, may indicate the activity is not engaged in for a profit. If the losses are sustained because of unforeseen circumstances, which are beyond the control of the taxpayer, such as disease, theft, fire, drought, weather conditions, other involuntary conversions or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. However, several years of profit would strongly indicate the activity is a for profit operation. This factor is important as the rules focus on the lack of profit potential for a specific activity. The lack of a profit motive is initially triggered by a history of losses. If you are growing a business, such as raising a cattle herd, this factor may be easier to meet.

7. **The amount of occasional profits, if any, which are earned**

The amount of occasional profits in relation to the amount of losses incurred, the amount of the taxpayer's investment, and value of the assets used in the activity, may indicate whether or not the activity is engaged in for a profit. Substantial profits, though only occasional, generally would indicate a profit motive, especially where the losses and investment are comparatively small. Alternatively, an occasional small profit from an activity having large losses, or an activity where the taxpayer has a large investment, may indicate a lack of profit motive. However, the opportunity to ultimately earn a substantial profit in a highly speculatively venture is usually sufficient to indicate a profit motive even though small occasional profits and large losses are currently being generated. Demonstrated opportunity to make profits through growth and increased revenue, expanding the revenue base, and not just cutting expenses, generally indicates the activity is engaged in to make a profit.

8. **<u>The financial status of the taxpayer</u>**

The fact that the taxpayer’s only source of income is from the activity in question may indicate the activity is engaged in for a profit. In addition, a profit motive may be indicated if the activity is required to maintain the taxpayer’s lifestyle. On the other hand, substantial income from other sources coupled with losses from the activity that generate a tax benefit, may indicate the activity does not have a profit motive.

Some taxpayers may have the financial capacity to sustain losses for a number of years. If the taxpayer is receiving a tax benefit from these losses (the losses offset substantial income from other sources) the IRS examiner may question why the taxpayer continues to operate an unprofitable activity when others without such financial wherewithal would have abandoned the activity. If personal or recreational elements are also involved; the taxpayer’s position is further weakened. Taxpayers with substantial other sources of income operating historically unprofitable activities have not fared well in Tax Court. This factor in some cases is confusing and arbitrary. A taxpayer needs capital to start a business and must have the financial wherewithal to ride out the early years, yet the examiner may attempt to use this against the taxpayer.

9. **<u>Elements of personal pleasure or recreation</u>**

The presence of motive other than profit and where personal pleasure or recreational elements are involved would indicate the activity may not be for profit. Conversely, where an activity lacks any appeal other than profit usually indicates a profit motive. Personal pleasure or recreation derived by use of the taxpayer’s activity by relatives will also be a consideration in the examiner’s determination.

It is not necessary that an activity be engaged exclusively to derive a profit or maximize profits. That is to say, the availability of other investments that might produce a higher return, or which may be more profitable, is not evidence that the activity is not engaged in to make a profit. An activity should not be considered not for profit merely because the taxpayer has other purposes or motivations other than solely to make a profit. In addition, the fact that a taxpayer derives personal pleasure from the activity does not in itself cause the activity to be considered as not for profit if in fact the activity is engaged in for profit as evidence by other factors whether or not listed in these articles. Occasional hunting or fishing on a farm or cattle ranch will not in itself indicate a lack of profit motive. Initial intent is also considered. For example, a doctor purchased a farm with the intention of moving to the farm after retirement. Upon retirement the doctor moved to the farm and invested in renovating the farm house. The doctor did not do well in substantiating the farm as a business as his intent in purchasing the farm was personal and his additional investment did nothing to improve or increase farm revenues. The fact that a taxpayer enjoys the activity may cause that activity to be questioned.

Naturally, a taxpayer will attempt to downplay personal or recreational pleasure in an activity and the auditor will take the opposite approach. The auditor will be aware that the taxpayer and his or her tax advisor will also be familiar with the nine relevant factors.

Summary

One of the most important items in defending your position is to **know your activity and why you consider it a business. You should be able to describe your business in detail, how and when you expect to begin making profits and thought on what changes or improvements may need to be made in the future to fortify the success of the business**. This is a tall order, but one that can be done.

Have a business plan and **know it**. This goes along with our first point. Conduct your activity as a business and use good business practices. Maintain a separate checking account regardless of the business size. Keep complete and accurate records of your business activity, with supporting documents and a **log of your participation in the business. Engage a technical expert as well as a tax and financial professional**.

Let's look at the nine relevant factors. The first three are factors that you can control to a large extent. Be on top of these factors from the start and be able to support your position. The fourth factor may be more difficult to meet and verify, and you should be aware of this. Also, be aware of the fact that the IRS examiner will give equal weight to this factor alone as he or she will give to the first three factors combined. Factor No. 5 should not prove difficult to win if you have been successful in other ventures. The next three factors: 6,7 and 8 are more factual in nature. You will either meet these factors or you will not. Keep in mind, when considering factor No. 7, the ultimate expectation of eventual profit should overcome current losses. The 9th factor may be the factor that can swing the balance in your favor, or conversely, cost you your tax deduction.**Be sure to emphasize those factors that are in your favor.**

If your business is audited, be up front as much as possible. Choose your words carefully. As an example, if you are running a hunting preserve, calling yourself an avid hunter and hunting at every possible opportunity may indicate personal pleasure. Calling yourself an experienced hunter, a quality that would aid in running the preserve would be a much better choice. Remember, contact your tax advisor immediately if you receive an "intent to audit" notice. As previously stated, wealthier taxpayers may be higher on the audit list, but that is not the only indicator the IRS considers. Congressional records indicate the original intent of the hobby loss rules were to curtail doctors' investing in farming as a presumed method of obtaining a tax benefit.

As mentioned earlier, this article and Part 1 in last month's issue primarily address a secondary business and not the taxpayer's primary source of income; although most of the article would still apply if the activity is the taxpayer's only source of income.

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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