AGRICULTURAL
FINANCIAL AND TAX PLANNING
What it is a Hobby Loss?

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During the year end tax planning, many ranchers are anticipating losses from their operations based on the current cattle market. This has caused a few to ask about the possibility of their operations being considered to be hobbies by the Internal Revenue Service (IRS). So we thought this may be a good time to discuss how an operation that is anticipating many years of losses may prepare to defend against any assertions by the IRS that their activity is a hobby. If the IRS is successful in such an assertion losses will be disallowed. Therefore, it is worth ones time to be prepared to defend against any hobby loss assertions. The following is a brief review of the hobby loss rules and some tips on how to avoid being trapped by those rules.

What is the Tax Code Hobby Loss Provision?

Internal Revenue Code Section 183 "hobby loss provisions" was enacted as part of the 1969 Tax Reform Act in an effort to limit abuse of high income earners from receiving tax benefits by deducting personal expenses related to hobby-like activities. Treasury apparently considered it particularly applicable to gentleman farming. This is indicated by its placement in the Tax Reform Act under Subtitle B-Farm Losses however these hobby loss provisions applies to any activity not engaged in for profit," Before the enactment of Code Section 183 the IRS used Sections 165, 162, 212, 270 and the regulations there-under against the taxpayers as possible means of disallowing hobby-like deductions. Section 183 attempted to codify the rules related to hobby losses that had been developed under those code sections.

What are the Rules?

Code Section 183 provides that if your operations are considered a not for profit activity than losses form that activity are non deductible. However, Code section 183 provides for a safe haven test as follows:

> "If the gross income derived from an activity for 2 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary or his delegate establishes to the contrary, such activity shall be presumed for the purposes of this chapter for such taxable year to be an activity engaged in for profit."

The presumption as enacted is a rebuttable presumption in favor of the taxpayer: if gross income exceeds certain deductions in two out of five years, the activity will be presumed to be engaged in for profit. Note that this section introduces a new word "activity" which is narrower then the normal "Trade or business". Be careful to develop documentation for each activity that occurs in your operation.

The rancher that fails to meet the safe haven criteria can still qualify his activity as a business, provided he can show that his activities were conducted with a profit-making motive or intent. Per the Treasury regulation Sect 1.183-2(b) there are 9 relevant factors that the IRS will consider in determining the profit making intent which are as follows:

1. The Manner in Which the Taxpayer Carries on the Activity
2. The Expertise of the Taxpayer or His or Her Advisors
3. The Time and Effort Expended by the Taxpayer in Carrying on the Activity
4. The Expectations That the Assets Used in the Activity May Appreciate in Value
5. The Success of the Taxpayer in Carrying on Other Similar or Dissimilar Activities
6. The Taxpayer's History of Income or Losses With Respect to the Activity
7. The Amount of Occasional Profits, if Any, Which Are Earned
8. The Financial Status of the Taxpayer
9. The Elements of Personal Pleasure or Recreation

The following excerpts from the 81 page IRS agent training guide that was prepared by the IRS Market Segment Specialist Program ("MSSP") provides some insight into how the IRS will review these factors. (Italics are our comments)

"Factor 1: The Manner in Which the Taxpayer Carries on the Activity

> **"Books and Records Used in the Activity" (***The IRS is looking for detailed records as we discussed in our September article. Take time to prepare them. Separate personal items from business by having separate bank accounts and when practical conduct the activity in a legal entity like an LLC.)*
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> **"Business Plan"** "The taxpayer should have a formal written plan. This plan should demonstrate the taxpayer's financial and economic forecast for the activity…A business plan should show a short range and long range forecast for the activity. The forecast should allow for changes due to potential unforeseen and fortuitous circumstances." *(The IRS is looking for detailed budgets, cost analysis and long term forecast as we discussed in our August article)*
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> **"Methods of Operation"** ,,,*d*enote changes in the method of operation over the years and indicate why these changes were initiated. *(The IRS is looking for cost analysis and market analysis. They are also looking for documentation of changes in operations and adjustments in your long term planning as a result of those analyses. Minutes of meetings is one example of this documentation as discuss in our October communication article)*

“Efficiency of Operation” “denote whether the taxpayer is making changes to the operation that will result in improved operational efficiency. “

“Factor 2 The Expertise of the Taxpayer or His or Her Advisors”

“The examiner should document the expertise and knowledge of the taxpayer regarding the activity. The examiner should also document any advisors or experts that the taxpayer has used. Documentation should be prepared which shows specific instances where the taxpayer has followed the advice of the advisor. Documentation should also show how the advice affected the operation of the activity. The examiner should especially note instances when the taxpayer has ignored the recommendations of the advisor and why that decision was made.” *(document communication)*

“Factor 3: The Time and Effort Expended by the Taxpayer in Carrying on the Activity

“The amount of time devoted to the activity may be an indicator of profit motive. If the taxpayer employs competent and qualified individuals to operate the activity, then the taxpayer’s time and effort will be reduced.”

“The time analysis should precisely detail how much time the taxpayer devotes to each task related to the activity. The examiner should consider whether IRC 469 Passive Activity provisions might be applicable. IRC 469 could provide an alternative position for IRC section 183.” *(maintain records of personnel activities)*

Factor 4: The Expectations That the Assets Used in the Activity May Appreciate in Value

“According to the Treasury Regulations, Factor 4 states that the term “profit” also includes the appreciation of assets, such as land, used in the activity. An overall profit may occur, in spite of losses from current operations, if the appreciation of the assets is realized.”

“The examiner needs to determine if a potential for asset appreciation exists. The examiner can use comparables for this determination. The examiner also needs to determine whether the operation of the activity and the holding of the land are considered a single activity or separate activities.”

“In the instances of single activities, the history of losses from current operations will be offset by the future potential gain. In the instances of separate activities, the taxpayer cannot offset current operating losses by future potential gains. A determination of separate activities will result in the taxpayer not meeting Factor 4." (*note the new term "activity" verses "trade or business" and the need to identify all "activities" in your operations and the assets that are related to each*)

Factor 5: The Success of the Taxpayer in Carrying on Other Similar or Dissimilar Activities

"The examiner needs to document the financial successes that the taxpayer has had with other activities. A statement should also address specific instances where the taxpayer has abandoned any activities."

Factor 6: The Taxpayer's History of Income or Losses With Respect to the Activity

"Factor 6 is one of the most important factors of the nine. This factor supports the framework of this Code section."

"IRC section 183 focuses on the lack of profit potential for a specific activity. The question regarding profit motive is initially triggered by history of losses. For this reason, the development of this relevant factor provides the framework for this section. Examiners should not base any conclusions using this relevant factor alone." *(Detailed budgets, and long term forecast as we discussed in our August article are a defense against this short sighted view by the IRS. Documenting intentions of growing a herd results in expectations of 8 to 10 years of losses while heifers are retained to grow the herd verses staring a ranching activity by purchasing a herd may result in expectations of only 3 years of losses.)*

Factor 7: The Amount of Occasional Profits, if Any, Which Are Earned

"The examiner should consider the amount of occasional profits that the activity may generate."

Factor 8: The Financial Status of the Taxpayer

"In general, taxpayers who have other substantial sources of income have the financial wherewithal to sustain a history of losses with respect to cattle or horse activities. Some taxpayers actually derive a tax benefit from participation in these activities since the losses offset the other sources of substantial income."

Factor 9: The Elements of Personal Pleasure or Recreation

"The examiner needs to address the pleasurable and recreational aspects of the activity. The examiner should remember that taxpayers are willing to overlook the drudgery of certain tasks when the pleasurable aspects outweigh the negatives."

Note that meeting of five of the nine factors results in taxpayer wins at the audit level. Meeting those factors require good records and documentation.

There are court cases that show the importance of good documentation. An example of this was the case of Garbini v. Commissioner, T.C. Summary Opinion 2004-7. This involved the issue of whether the taxpayers were engaged in an activity for profit in connection with a cattle and horse breeding operation in Myrtle Creek, Oregon. Mr. Garbini, the taxpayer, did not maintain good books and records. He never prepared budgets or market forecast which supported strategies for a profitable business venture. He had no documentation that indicated what efforts he actually made to reduce expenses. Mr. Garbini worked on the ranch almost every day and employed one full-time ranch hand. He had no sales. Mr. Garbini testified, without any documentation, he bought the property for $566,000 in its undeveloped condition, and at the time of trial it was worth $15 million. The court ruled to disallow the deduction in the years in question since the taxpayer had minimal records to support his profit intent.

That was also the issue in the Tax Court case, Ralph Wesinger, Jr., v. Commissioner of Internal Revenue Wesinger owned a lucrative computer servicing business in San Jose, CA. He purchased two parcels of unimproved land and started a cattle ranch. Again the court disallowed his deductions. Stating there was no formal business plan, and not even an informal "plan for success."

As stated above the IRS feels that factor 6 is the most important factor for consideration. However, the Courts seem to believe that factor 1 is the most important. When a taxpayer operates his activities in a very business like manner with well documented profit plans, accounting records, cost analysis and good communications showing reasonable efforts to achieve goals that will lead to a profit, the courts have ruled in the taxpayers favor. However, those that do not have those records are likely to fall victim of the "Hobby loss Provision".

Summary

As stated in our last few monthly articles, starting last summer, it is very important to maintain good accounting records which include a short term and long term business plan, budgets, cost control analysis and documented communication of decision to improve the potential profitability of your operations. Your financial advisor should be able to provide some guidance to help you lower your exposure to the hobby loss provisions.

For more information on this topic and other tax and financial planning for ranching, please contact me at (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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