

## **IRS Facts – Is It a Hobby or A Business?**

We have all heard that a farm is considered a farm if it generates \$1,000.00 in annual income but..... what about the I.R.S.?

The attached article from the Alabama Cooperative Extension System might help to explain what is needed for your farm to be considered a business.

### **IRS Guidelines**

- You carry on the activity in a business-like manner.
- The time and effort you put into the activity indicate you intend to make it profitable.
- You depend on the income for your livelihood.
- Your losses are due to circumstances beyond your control (or are normal in the start-up phase of your type of business).
- You change your methods of operation in an attempt to improve profitability.
- You (or your advisors) have the knowledge needed to carry on the business in a profitable manner.
- You were successful in making a profit in similar activities in the past.
- The activity makes a profit in some years.
- You can expect to make a future profit from the appreciation of the assets used in the activity.

The article below explains the details of why you might be audited for each of these items.

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# TIMELY INFORMATION

## Agriculture & Natural Resources

### Is My Farm a Hobby or Business?

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Farm Management and Agricultural Enterprise Analysis

**Your tax return has been selected for examination by our office.**

These are words that no tax payer wants to read from either the IRS or the Alabama Department of Revenue. Recently a farm spouse told the story of their on-going state tax audit. It was a familiar one with a sad ending.

- Husband and wife owned and operated a small cattle farm.
- They both had full time off-farm employment.
- Worked hard, but lost money for the last 10 years on their Schedule F - Farm Tax Return as a sole proprietor.



**Initial Finding by Auditor:** Farm not business, but hobby. Hobby tax losses not allowable on all tax years under examination. Taxable income increased by the amount of tax losses. Additional prior year taxes and possible interest and penalties due upon completion of the audit.

The auditor's findings could have been avoided if the farmer was knowledgeable of the guidelines published by the IRS and Alabama Department of Revenue for all small businesses (which includes small farmers and ranchers).

The Internal Revenue Service Code 183 (d) deems that the taxpayer enters into an activity for a profit and can deduct all related business expenses if the business makes a profit 3 out of 5 consecutive years. If breeding, training, showing, or racing horses, it is considered a for-profit business if a profit is made in 2 out of 7 consecutive years. When this threshold of profitable years is not met, the taxpayer has the burden of proving that he/she entered in to the farming activity with a profit motive. Taxpayers should not single out one factor to determine whether the business is for profit, because the IRS takes all of the following points into consideration.

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The 2010 edition of IRS Publications 535 – *Business Expenses* and 225 – *Farmers Tax Guide* list the following nine items as determining factors in whether a business is a “Not-for-Profit Activity”.

1. You carry on the activity in a businesslike manner.
2. The time and effort you put into the activity indicate you intend to make it profitable.
3. You depend on the income for your livelihood.
4. Your losses are due to circumstances beyond your control (or are normal in the start-up phase of your type business).
5. You change your methods of operation in an attempt to improve profitability.
6. You (or your advisors) have the knowledge needed to carry on the activity as a successful business.
7. You were successful in making a profit in similar activities in the past.
8. The activity makes a profit in some years.
9. You can expect to make a future profit from the appreciation of the assets used in the activity.

The Alabama Department of Revenue (ADOR) has similar criteria for determining whether a farming activity is engaged in for a profit. Their nine factors are shown below, along with the situation for the audited farm.

ADOR Guidelines used by the Auditor	Audited Farm Situation
<b>1. Manner in which the activity is conducted.</b> <ul style="list-style-type: none"> <li>• Maintenance of checking accounts separate from personal accounts.</li> <li>• Presentation of a formal written Business Plan.</li> <li>• Preparation of budgets</li> <li>• Maintenance of business books and records.</li> <li>• Preparation of financial statements.</li> </ul>	<ul style="list-style-type: none"> <li>• No separate checking account for farm (personal and farm funds inter-mingled).</li> <li>• No business plan</li> <li>• No annual budget</li> <li>• No books and records other than check book and bank statements with sack of receipts and expenses for tax preparer at end of year.</li> <li>• No financial statements other than tax return.</li> </ul>
<b>2. Expertise</b> <ul style="list-style-type: none"> <li>• Established business based on extended study of similar businesses and consultation with experts, which indicate a profit motive.</li> <li>• Personal background in activity.</li> </ul>	<ul style="list-style-type: none"> <li>• Member of state cattlemen association</li> <li>• Regularly read and studied cattle publications</li> <li>• Had not consulted with Extension cattle specialist or other cattle consultant since mid- 1990's on improving operations.</li> </ul>
<b>3. Time and effort expended in carrying on the activity.</b> <ul style="list-style-type: none"> <li>• Significant percentage of time devoted to activity.</li> </ul>	<ul style="list-style-type: none"> <li>• Farmer and spouse both had full time off –farm employment.</li> <li>• Required to document the amount of time spent in ranch business to establish how active they were in farming.</li> </ul>
<b>4. Expectation that assets used in activity may appreciate in value.</b> <ul style="list-style-type: none"> <li>• The taxpayer may intend to derive profit from the increase in value of assets even though there may not be a short term annual profit.</li> </ul>	<ul style="list-style-type: none"> <li>• Initial land was inherited.</li> <li>• More land had been rented to expand herd.</li> </ul>
<b>5. Success in carrying on other similar or dissimilar activities.</b> <ul style="list-style-type: none"> <li>• Financial success in other activities.</li> </ul>	<ul style="list-style-type: none"> <li>• Husband and spouse non-farm jobs were not in agriculture.</li> <li>• No previous experience in owning any other small business.</li> </ul>
<b>6. History of income or losses with respect to the activity.</b> <ul style="list-style-type: none"> <li>• Series of losses indicate lack of profit motive</li> </ul>	<ul style="list-style-type: none"> <li>• Ten years of losses with no reported profits.</li> <li>• Respond to question: “<i>Why would a reasonable</i></li> </ul>

<ul style="list-style-type: none"> <li>• Indication of a trend toward profitability.</li> </ul>	<p><i>person stay in business for ten years with continuing losses?"</i></p>
<b>7. Amount of occasional profits, if any, which are earned.</b> <ul style="list-style-type: none"> <li>• Occasional substantial profit indicates profit motive.</li> <li>• Profits should be in line with time and financial investment in the activity.</li> </ul>	<ul style="list-style-type: none"> <li>• No profits reported in ten years.</li> <li>• W-2 wages subsidize farm losses.</li> </ul>
<b>8. Financial status of the tax payer.</b> <ul style="list-style-type: none"> <li>• Substantial income from other sources may suggest that the activity is not engaged in for profit especially if there are personal or recreation elements involved.</li> </ul>	<ul style="list-style-type: none"> <li>• W-2 non-farm earnings had subsidized cattle operations for multiple years with no reported profits.</li> <li>• Tax payer and spouse reported they enjoyed raising cattle and living in a farm environment for themselves and their children.</li> </ul>
<b>9. Elements of personal pleasure or recreation</b> <ul style="list-style-type: none"> <li>• Presence of personal motives other than profit.</li> <li>• Potential to continue the activity without ever making a profit.</li> </ul>	<ul style="list-style-type: none"> <li>• Farm lifestyle was preferred by tax payer and spouse.</li> <li>• Ten year history with no profits and no plans to discontinue raising cattle prior to the audit.</li> </ul>

#### Concluding Comments:

This small farmer and rancher would sound very familiar to any Extension professional in agriculture. After reading these guidelines, here are some suggestions for any farmer or rancher you work with.

- Get the facts – read the appropriate tax publications.
- Understand the state financial and political environment – If taxes cannot go up, one option to increase revenue is to more stringently enforce existing tax regulations.
- Sole Proprietor farmers and ranchers are considered self-employed, with significant opportunities to under-report taxable income and use the farm as a tax-write-off to avoid tax on non-farm income.
- The farmer should strongly consider seeing their tax-preparer prior to each year end to review year-to-date sales and expenses for tax planning purposes, particularly if they have not reported any Schedule F profits in the last four years.

Finally, as Extension professionals, we all can ask two questions: *Mr. & Mrs. Farmer (or Rancher), does this article sound like you? What can I do to help?*

#### Useful Websites:

IRS Farmers' Tax Guide (IRS Publication 225) explains how federal tax laws apply to farming, [www.irs.gov/pub/irs-pdf/p225.pdf](http://www.irs.gov/pub/irs-pdf/p225.pdf)

IRS Business Expenses (IRS Publication 535) [www.irs.gov/pub/irs-pdf/p535.pdf](http://www.irs.gov/pub/irs-pdf/p535.pdf).

Alabama Cooperative Extension System (ACES) Farm Management and Agricultural Enterprise Analysis Program, can provide technical assistance with complying with state and federal guidelines, [http://www.ag.auburn.edu/agec/farm\\_analysis.php](http://www.ag.auburn.edu/agec/farm_analysis.php)