

## FAQ 14

### Is My Farm a Business or a Hobby (Not-for-Profit) Farm?

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Some farms show losses year after year, and there is concern that the IRS may consider the farm a “hobby” or what the tax law refers to as a “not-for-profit” activity rather than a “trade or business.” Classification as a not-for-profit activity restricts the deductibility of many expenses. Activities with significant elements of personal pleasure, like riding horses, are more likely to be questioned. The nine factors test used by the IRS and the tax courts is briefly described below.

#### **Tax Management: Hobby (Not for Profit) Farm vs. Business**

**Does failure of a farm to show a profit mean expenses are not deductible for tax purposes?** Tax law makes a distinction between a “trade or business” and a “hobby.” If an activity shows a profit in 3 of 5 years (2 of 7 years for horse-related activities), the activity is presumed to be a trade or business and all of the expenses are deductible on Schedule F (farm income and expenses). However, if an activity is a hobby, then the deductible hobby-related expenses cannot exceed the gross receipts of the hobby. Furthermore, these expenses, other than interest and real estate taxes, are only deductible on Schedule A (itemized deductions) to the extent they exceed 2% of the total adjusted gross income of the individual.

**Failure to show a profit in 3 of 5 years does NOT automatically make an activity a hobby.** However, the taxpayer will have the burden of proof that the activity has a profit motive in an audit situation. Part-time and farms involved in “new” or alternative enterprises may be questioned with respect to their profit motive.

There are nine factors that are considered in determination of a profit motive:

#### **1. Manner in which the taxpayer carries on the activity**

Does the taxpayer keep accurate books and records? Is the activity conducted in a business-like manner? Does the taxpayer conduct the activity like similar activities that do show a profit?

#### **2. Expertise of taxpayer or his advisors**

Has the taxpayer prepared to conduct the business (education, training in accepted practices)? Does taxpayer consult with experts (Extension Educators)? If common production practices are not used, is the taxpayer attempting to develop new or superior techniques that may result in profits?

#### **3. Time and effort expended by taxpayer in the activity**

Spending a lot of time in the activity, especially if there are no substantial personal or recreational aspects, is indicative of an intention to make a profit.

#### **4. Expectation that assets used in activity may appreciate in value**

This needs to be more than just the value of the land is expected to go up. Will the increase in value of the assets be enough to cover the costs of the activity?

**5. Success of taxpayer in similar or dissimilar activities**

Does the taxpayer have a record of turning unprofitable activities into profitable ones?

**6. History of income and losses with respect to the activity**

Is the activity in the “start-up” phase when losses would be expected? Do losses continue without a reasonable explanation (drought, disease, weather damage, low prices) that is outside control of the taxpayer? Years of previous profits followed by years of losses can be strong evidence of profit motive.

**7. Amount of occasional profits, if any, earned**

Substantial profit, even if only occasional, is indicative of a profit motive. An occasional small profit on a large investment (perhaps from cooking the books) suggests lack of profit motive.

**8. Financial status of taxpayer**

If the taxpayer does not have substantial income or capital from sources other than the activity, this suggests activity has a profit motive. Substantial income from other sources, especially if the activity generates big tax benefits, indicates activity is not profit motivated. If the activity involves significant personal or recreational elements, then it may be difficult to show a profit motive. (High-income individuals with show horses generally get clobbered in court.)

**9. Elements of personal pleasure or recreation**

Tax law allows a taxpayer to enjoy what they do. However, unless there are aspects of the “pleasureful” activity that do show a profit motive, the taxpayer may be in trouble.

There is no one factor that is dominant in the determination. One also does not keep score. It is a “facts and circumstance” situation. Most situations are clear-cut. Many small, part-time farms may not show a profit but still can have a profit motive. However, high off-farm income and “new toys” could open the door to questions.

In recent cases, the courts have given considerable emphasis to the existence of a business plan. Without a written business plan, it is difficult to convince the court that there is business intent.

**Resources for Distinguishing Farm Businesses from Hobby Farms**

Resources	Sources
<i>The Farmer's Tax Guide</i> (IRS Pub. 225). See the end of Chapter 5, “Not for Profit Farming.”	<a href="http://www.irs.gov/pub/irs-pdf/p225.pdf">http://www.irs.gov/pub/irs-pdf/p225.pdf</a>
Section 183: <i>Farm Hobby Losses with Cattle Operations and Horse Activities</i>	<a href="http://www.irs.gov/pub/irs-mssp/a1farmls.pdf">http://www.irs.gov/pub/irs-mssp/a1farmls.pdf</a>

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