Hobby Loss Provision

There is nothing wrong with deducting losses from a farm business. However, when a taxpayer incurs losses from farming activities for several years, and those losses are deducted from other unrelated income, the Internal Revenue Service may begin to question whether the farm activities are actually a hobby of the taxpayer, not a business. If the farm activities are a hobby, then income must be reported and expenses can be deducted but only to the extent of the hobby income.

If the IRS declares the taxpayers farm activity to be a hobby, it can re-compute the tax liability for current and past years. This can be financially devastating after interest and penalties are added to the tax bill. The major question is whether your farm business was engaged in for the purpose of turning a profit. If you began the venture intending to turn a profit, then your losses are indeed business loses, not hobby loses. However, year after year of losses can cause the IRS to become curious and ask why you persisted in engaging in a losing business activity for several years? *The essential ingredient that is required for a farm activity to be treated as a business by the IRS is the presence of a profit objective.*

Three Year out of Five Year Presumption (two out of seven for cattle and horse ranching)

The tax code provides that if a farm activity shows profits in three years during a *specified* five-year period, that activity will be 'presumed' to be a business. For those years covered by this presumption the *burden of proof* is placed on the IRS that the activity is actually a hobby and not a business. When the presumption applies, it protects only the third profit year and each of the tax years after the third profit year which fall within the five-year period which began with the first profit year.

Which years are covered by the 'presumption' that this business activity has a profit motive?

P = profit year L = loss year

2001	2002	2003	2004	2005	2006	2007	2008	2009
L	L	P	P	L	P	L	L	L

In the above example, the five years begin with the first profit year, 2003, and end in the fifth year, 2007. The only years covered by the presumption are those years that begin with the third profit year, 2006. So, in the above example, only years 2006 and 2007 are covered. There is no presumption for tax years 2001 through 2005 or for 2008 and 2009 that the activity was a business and not a hobby.

Which years are covered by the 'presumption' that this business activity has a profit motive?

P = profit year L = loss year

2001	2002	2003	2004	2005	2006	2007	2008	2009
L	L	P	P	P	L	L	L	L

Tax years 2005 - 2007 are covered in the above example. However, the presumption can still be overcome by evidence that shows lack of a profit motive. All the presumption does is to place the burden upon the IRS to show the activity was a hobby. In 1998, Congress placed the burden of proof on the IRS, but this general rule probably does not apply to the hobby loss cases.

Nine Hobby Loss Factors Considered in Determining Whether an Activity is a Business

1. **Operation of activity in a business-like manner.** Do you keep complete and accurate books and records? Are the business accounts kept separate from personal accounts? Have you abandoned unprofitable business pursuits? Is there a written business plan showing how you operate your business and how you plan on becoming profitable?

2. **Expertise.** Do you have the knowledge and skills required to engage in the business activity? Were experts hired or engaged for advice? Do you work at becoming more knowledgeable about farming and the farming industry?

3. **Time and Effort.** Do you devote substantial time and effort to the activity? Devoting limited time does not mean the taxpayer did not intend to turn a profit if he or she employs other competent and qualified people to carry on the activity. Do you keep a daily log of all your time spent on your farm business? Material participation is defined by the IRS as over 500 hours a year.

4. **Expectation that assets may appreciate.** The expectation of appreciation of assets, such as a orchard or a crop, is considered in determining whether the taxpayer intended to turn a profit. The expectation must be that the operating income and capital gains from selling the asset would more than cover the expenses involved in the activity. Do you research current market prices to help evaluate the current value of your business?

5. **Past successes in similar or dissimilar activities.** The taxpayer's past success in similar or dissimilar activities can be indicative of a profit objective. The fact that he or she has not engaged in past successful business activities counts against the taxpayer, but can be outweighed by other factors.

6. **History of income and losses.** A taxpayer's history of income, losses, and occasional profits with respect to an activity may indicate the presence or absence of a profit objective. Losses are the norm during the startup phase of a business and may not weigh as heavily against the taxpayer.

7. **Amounts of occasional profits.** The amounts of profits earned in the activity, when compared to the amount of losses incurred, the amount of the investment, and the value of the assets in use, may indicate a profit objective.

8. **Taxpayer's financial status.** The fact that the taxpayer does not have substantial income unrelated to the farm activity may indicate that the activity is engaged in for a profit. The cases in which the IRS challenges deductions under the hobby loss rule are often cases in which the taxpayer has substantial income from sources unrelated to the farm business.

9. **Personal pleasure or recreation.** The presence of personal pleasure or recreation may indicate the lack of a profit motive. Farming can bring pleasure as well as requiring a great deal of work. However, the mere fact that the taxpayer enjoys the activity does not mean it was not engaged in to make a profit. The IRS cannot rule against you for loving your work.

1. Record Keeping. Everyone in business must keep records. Good records will help you do the following:

***Monitor the progress of your business*.** You need good records to monitor the progress of your business. Records can show whether your business is improving, which items are selling, or what changes you need to make. Good records can increase the likelihood of business success.

***Prepare your financial statements*.** You need good records to prepare accurate financial statements. These include income (profit and loss) statements and balance sheets. These statements can help you in dealing with your bank or creditors.

***Identify source of receipts*.** You may receive money or property from many sources. Your records can identify the source of your receipts. You need this information to separate business from nonbusiness receipts and taxable from nontaxable income.

***Keep track of deductible expenses*.** You may miss deductible expenses when you prepare your tax return unless you record them when they occur.

***Prepare your tax returns*.** You need good records to prepare your tax return. These records must support the income, expenses, and credits you report. Generally, these are the same records you use to monitor your business and prepare your financial statements. Without good records deductions may be missed and tax preparers may charge more if the records are not in order.

***Support items reported on tax returns*.** You must keep your business records available at all times for inspection by the IRS. If the IRS examines any of your tax returns, you may be asked to explain the items reported. A complete set of records will speed up the examination.

2. Business checkbook. One of the first things you should do when you start a business is open a business checking account. You should keep your business account separate from your personal checking account. The business checkbook is your basic source of information for recording your business expenses. You should deposit all receipts in your business checking account. You should check your account for errors by reconciling it. You should make all payments by check or business credit card to document business expenses. Write checks payable to yourself only when making withdrawals from your business for personal use. Avoid writing checks payable to cash.

3. How Long To Keep Records. You must keep your records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, this means you must keep records that support an item of income or deduction on a return until the period of limitations for that return runs out. The period of limitations is the period of time in which you can amend your return to claim a credit or refund, or the IRS can assess additional tax. The IRS has three years from the date you file your return to assess any additional tax. If you file a fraudulent return or no return at all, the IRS has a longer period of time to assess additional tax. If you have employees, you must keep all employment tax records for at least four years after the date the tax becomes due or is paid, whichever is later. Keep records relating to property until the period of limitations expires for the year in which you dispose of the property in a taxable disposition. You must keep these records to figure any depreciation, amortization, or depletion deduction, and to figure your basis for computing gain or loss when you sell or otherwise dispose of the property. When your records are no longer needed for tax purposes, do not discard them until you check to see if you have to keep them longer for other purposes. For example, your insurance company or creditors may require you to keep them longer than the IRS does. *Whichever system you use to record business transactions will be most effective if you follow good recordkeeping practices.*

4. Kinds of Records To Keep. Except in a few cases, the law does not require any special kind of records. You may choose any recordkeeping system suited to your business that clearly shows your income. The business you are in affects the type of records you need to keep for federal tax purposes. You should set up your recordkeeping system using an accounting method that clearly shows your income for your tax year. If you are in more than one business, you should keep a complete and separate set of records for each business. For most small businesses, the business checkbook is the main source for entries in the business books. In addition, you must keep supporting documents, such as sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks. These documents contain the information you need to record in your books.

5. Business Deductions

Business use of your car or truck. If you use your car or truck in your business, you can deduct car or truck expenses. This deduction is often under utilized by harried business owners who don't have time to keep good records of their mileage driven for business purposes and/or car or truck repair and maintenance expenses over the year**.** If you use your car or truck for both business and personal purposes, you must divide your expenses based on mileage. Only your expenses for the miles you drove the car or truck, for business, are deductible as business expenses. You can use either the standard mileage rate or actual expenses to figure the deductible cost of your vehicle. Actual car or truck expenses, include depreciation (or lease payments), gas and oil, tires, repairs, tune-ups, insurance, and registration fees. For more information on car or truck expenses and the rules for using the standard mileage rate, see IRS Publication 463.

Travel, Meals, and Entertainment. Travel expenses include the ordinary and necessary expense of traveling away from home for your business. The expense of meals and lodging are deductible if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties. In most cases you can only deduct 50% of your meal expenses. You may be able to deduct business-related entertainment expenses you have for entertaining a client, customer, or employee. In most cases you can deduct only 50% of these expenses.

Insurance. You can generally deduct premiums you pay for equine mortality, fire, theft, flood, vehicle, liability, malpractice, and workers' compensation insurance. Also, you may be able to deduct a portion of the amount you pay for medical insurance for yourself and your family.

Supplies. Materials and supplies required to operate your business should be categorized as either office supplies, general business supplies, or manufacturing materials and supplies.

Taxes. You can deduct employment taxes, generally half of you self employment tax, property tax on business assets, real estate taxes on business property, sales tax on a service or the purchase of property.

Depreciation. This is a complex deduction. If property you acquire to use in your business is expected to last more than one year, you generally cannot deduct the entire cost as a business expense in the year you acquire it. You must spread the cost over more than one tax year and deduct part of it (depreciate) each year. It is beyond the scope of this publication to instruct you on how to depreciate your business assets. Your tax preparer can determine the appropriate depreciation schedule for each of your assets depending on the type of asset, year of purchase, and business purpose.

Employee wages and Employer taxes . Employment taxes are complex. It is beyond the scope of this publication to instruct you in how to prepare all the different aspects of payroll taxes. There are many payroll companies today that can help you with your business payroll.

Subcontractors. If you have sub contractors you must file a Form 1099-MISC, *Miscellaneous Income* for each subcontractor you paid over $600. Subcontractors are people not treated as your employees. You do not need to file a Form 1099-MISC for any subcontractor that is incorporated.

Personal Expenses taken on Your Business Tax Return. Generally, you cannot deduct personal, living, or family expenses. However, if you have an expense for something that is used partly for business and partly for personal purposes, divide the total cost between the business and personal parts. You can deduct as a business expense only the business part.

Business use of your home. If you use part of your home in your business, you may be able to claim part of the expenses of maintaining your home as a business expense. These expenses include mortgage interest, insurance, utilities, repairs, and depreciation. The business use of your home must meet specific requirements before you can take any of these expenses as business deductions. For more information, see IRS Publication 587.

6. Forms of Business Organization

Sole proprietorships. A sole proprietorship is an unincorporated business that is owned by one individual. It is the simplest form of business organization to start and maintain. The business has no existence apart from you, the owner. Its liabilities are your personal liabilities and you undertake the risks of the business for all assets owned, whether or not used in the business. You include the income and expenses of the business on your own tax return (Form 1040).

Partnerships. A partnership is the relationship existing between two or more persons who join to carry on a trade or business. Each person contributes money, property, labor, or skill, and expects to share in the profits and losses of the business. A partnership must file an annual information return (Form 1065) to report the income, deductions, gains, losses, etc., from its operations, but it does not pay income tax. Instead, it "passes through" any profits or losses to its partners. Each partner includes his or her share of the partnership's items on his or her tax return (Form 1040).

Corporations. In forming a corporation, prospective shareholders transfer money, property, or both, for the corporation's capital stock. A corporation generally takes the same deductions as a sole proprietorship to figure its taxable income. A corporation can also take special deductions. The profit of a corporation is taxed to the corporation when earned, and then is taxed to the shareholders when distributed as dividends. However, shareholders cannot deduct any loss of the corporation.

S Corporations. An eligible domestic corporation can avoid double taxation (once to the corporation and again to the shareholders) by electing to be treated as an S corporation. An S corporation generally is exempt from federal income tax other than tax on certain capital gains and passive income. Its shareholders include on their tax returns their share of the corporation's separately stated items of income, deduction, loss, and credit, and their share of nonseparately stated income or loss.

7. References

- ✓ To order IRS forms, instructions and publications call 1-800-829-3676.
- ✓ To ask the IRS tax questions call 1-800-829-1040
- ✓ To listen to pre-recorded messages covering various tax topics call 1-800-829-4477.
- ✓ For help from the Small Business Administration call 1-800-8-ASK-SBA
- ✓ For IRS forms and publications and general information http://www.irs.ustreas.gov/

Helpful IRS Publications

- ✓ 334 Tax Guide for Small Business
- ✓ 17 Your Federal Income Tax
- ✓ 225 Farmer's Tax Guide.
- ✓ 463 Travel, Entertainment, Gift, and Car or truck Expenses
- ✓ 547 Casualties, Disasters, and Thefts (Business and Nonbusiness)
- ✓ 587 Business Use of Your Home
- ✓ 946 How To Depreciate Property

IRS forms used in business

- ✓ Schedule F (Form 1040), Profit or Loss from Farming
- ✓ Form W-9, Request for Taxpayer Identification Number and Certification Form
- ✓ SS-4, Application for Employer Identification Number
- ✓ Form 1040-ES, Estimated Tax for Individuals
- ✓ Form 1099MISC, Miscellaneous Income
- ✓ Form 9465, Installment Agreement Request
- ✓ Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return