

# New Farmer Series

## Is My Farm Activity a Hobby or a “For Profit” Business?

The number of part-time farm operations in Vermont is on the rise, even though the number of full time farm operations in Vermont is decreasing. This rise in part-time agricultural ventures helps maintain the working landscape; contributes to the agricultural economy; supports businesses that sell agricultural supplies and services; and helps to educate consumers about the importance of Vermont agriculture.

However, along with the increase in part-time ventures comes the question: Is the farm activity a hobby or is it a “for Profit” business?

Why stipulate the difference between a farm hobby and a business? It is an attempt at fairness. The hobby loss rules of IRS code 183 are designed to prevent a taxpayer from deducting the cost of “toys” and paying abnormally low taxes. They do that by limiting a taxpayer’s deductions unless the taxpayer can show that she entered into an activity to make a profit.

On the other hand, when a farmer is in the business “for profit” then expenses associated with the business are deductible even though the business has a loss for several years. To clarify the difference the IRS has set out several rules and guidelines which are outlined below.

IRS Code 183(d) presumes the taxpayer enters into an activity for a profit if the activity shows a profit for 3 out of 5 consecutive years. If the activity shows a profit in 3 out of 5 years, (or 2 of 7 consecutive years for horse breeding, training, showing or racing) the taxpayer can treat the activity as a business and deduct all of the usual business expenses. Thus the burden of determining whether an operation is “not for profit” or a “hobby farm” is placed on the IRS and not on the taxpayer. On the flip side, the taxpayer not meeting the threshold of profitable years has the burden of proving that he or she entered into the farming operation with a profit motive.

In addition, the IRS has set out nine factors. If the taxpayer does not make a profit as described above, he may still be able to show the activity is a business. Regulations list these factors can be used as evidence that the activity is a business even though it is losing money.

You should take into account all of the following points to help prove that you are farming for profit. Below each statement



are questions and statements that will help clarify if the business is being operated “for profit” or as a hobby.

1. The manner in which the taxpayer carries on the activity.

- *Is the business operated in a business-like manner?*
- *Does the operation have complete and accurate books?*
- *Is the operator changing production methods trying for a profit?*
- *Does the farm have a business plan?*

2. The Expertise of the taxpayer or their advisors.

- *Has the taxpayer completed any study of business, economic, scientific practices before starting?*
- *If the taxpayer has learned about the above, but did not follow suggestions, it often shows a lack of intent of profit.*



3. The time and effort expended by taxpayer in carrying on the activity.

- *Do you devote much of your personal time and effort even though there may not be substantial personal or recreational aspects?*
- *Is there a withdrawal from another occupation to focus on this one?*
- *Note that the amount of time devoted alone does not show lack of profit motive.*

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

- *‘Profit’ includes appreciation in the value of assets used in the activity. Thus the taxpayer may intend to derive a profit via the increase value of assets even though there may not be a profit in the business in the short term.*

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

- *Did you do similar activities in the past and convert them from unprofitable into profitable activities?*



University of Vermont

Adams House, 601 Main Street, Burlington, Vermont 05401-3439

Director's Office: 802.656.2990 or 1.866.622.2990, 4-H: 1.866.800.9944, Fax: 802.656.8642

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

- *Losing money at start up is not the final word.*
- *Do losses occur due to circumstances beyond the control of the taxpayer?*
- *Several years of profit is strong evidence of profit motive.*

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

- *Are profits relative to the losses incurred over previous years?*
- *Are they in line with the time and financial investment into the activity,*

8. The financial status of the taxpayer is a factor.

- *Does taxpayer have income or capital from other activities?*
- *Does activity generate substantial tax benefits?*

9. The elements of personal pleasure or recreation is another factor.

- *Does taxpayer have personal motives for the activity in addition to the profit?*
- *Are there recreational or personal elements involved or is it part of the overall business plan?*
- *Personal pleasure is not the only factor.*



In addition to the nine factors there are other areas to consider including the Deductibility Ordering Rules for hobby losses.

You need to make a decision to farm for profit rather than "just for fun." Floating between the profit and pleasure worlds can be expensive in terms of taxes if you allow the IRS to determine that the business is a hobby, and then it disallows a large deduction on a particular return. Lurking on the edge of deciding about the seriousness of your operation will just lead to frustration and, yes, to the underreporting of expenses.

To get started, the small farmer must include a tax professional on his or her management team and then work hard to educate that person about the farm operation and his or her goals. For more information, please contact a professional tax preparer, or

### **Tips for getting your business off to a professional start**

- Keep business and personal expenses separate
- Set up a bookkeeping system
- Keep accurate records
- Make record-keeping a regular activity
- Set financial goals for your business and track progress
- Choose the right organizational structure for your needs
- Employ professionals to advise you in tax and legal issues

### **Websites you may find useful:**

- Your Federal Income Tax (IRS Publication 17) will answer your questions related to personal income tax. The publication can be viewed at <http://www.irs.gov/pub/irs-pdf/p17.pdf>.
- IRS Farmers' Tax Guide (IRS Publication 225) explains how the federal tax laws apply to farming. Find this publication at <http://www.irs.gov/publications/p225/index.html>.
- eXtension has many resources available on the business of farming as well as product-specific information. <http://www.extension.org>

### **The UVM Extension New Farmer Series:**

- **Enterprise Budgets**