Value Added Enterprises and Hobby Losses

Parman R. Green, Univ. UO&E Ag. Business Management Specialist

Is your value-added enterprise a "for profit" or a "hobby" activity. While few people would object to their hobby developing into a very profitable business, most hobbies are cash sink holes and are entered into with less concern for profit than pleasure and recreation. All new businesses must be developed and few are profitable during these developing years. What distinguishes a developing business from an expensive hobby?

First, you may be asking why should you care whether your activity is perceived as a business or a hobby? The answer – TAXES! IRS regulations have provisions that prevent a taxpayer from deducting losses resulting from a hobby against other taxable income. Expenses and deductions of an activity that is labeled a hobby are basically limited to the income generated by that activity. For example, if your "hobby" incurred $25,000 of general operating expenses and only generated $10,000 of income, the $15,000 excess expenses are non-deductible.

As one might expect, if an activity is going to produce substantial excess expenditures, many people will attempt to categorize the activity as a business venture. While most businesses are clearly and easily recognized as being "for-profit", however, some are less obvious and definitive. The IRS has identified a number of factors they consider when evaluating the "profit intentions" of an activity. No one factor is decisive and are all considered as a whole.

1. The activity is operated in a businesslike manner.
2. The time and effort spent in the activity indicates an intention to make it profitable.
3. Taxpayer depends on income from the activity for their livelihood.
4. Losses are due to circumstances beyond the taxpayer's control or are normal in the start-up phase of the activity.
5. Methods of operation are changed in an attempt to improve profitability.
6. The taxpayer, or the taxpayer's advisors, has the knowledge needed to carry on the activity as a successful business.
7. Taxpayer has made a profit in similar activities in the past.
8. Taxpayer reasonably expects to make a future profit from the appreciation of the assets used in the activity.

Additionally, the IRS regulations provide a "presumption of for-profit" if a taxpayer's farming or other activity produced a profit in at least 3 of the last 5 tax years, including the current year. If the activity consists primarily of breeding, training, showing, or racing horses – it is presumed to be for-profit if profit is produced in at least 2 of the last 7 tax years, including the current year.

Records are invaluable tools in distinguishing a business from a hobby – they can illustrate your:

- **evaluation and analysis** of the enterprise,
- **business plan**, and
- **management** of the enterprise.

Sources for additional information: The 2002 Farmer's Tax Guide, Publication 225, available through most extension offices has a short discussion of this topic listed under the title of Not-for-Profit Farming. An excellent resource is IRS publication "Farm Hobby Losses with Cattle Operations and Horse Activities". This is a Market Segment Specialization Program (MSSP) - available on the Web at: http://www.irs.ustreas.gov/pub/irs-mssp/a1farmls.pdf .

The important point to draw from this information is the need for documenting your intent and actions taken in the pursuit of profit. This is clearly an example of where the 'best offense is a good defense".