Recreational Farming and Hobby Losses
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The IRS regulations have provisions that prevent a taxpayer from deducting losses resulting from a hobby against other taxable income. As more and more people acquire small- to medium-size rural acreage, the chances of running afoul of the hobby loss rules are increased. Expenses and deductions of an activity that is labeled a hobby are basically limited to the income generated by the activity. For example, if your "hobby" incurred $25,000 of general operating expenses and generated $10,000 of income, the $15,000 excess expenses are non-deductible. Activities engaged in mainly for sport or recreation also come under this rule.

As one might expect, if an activity is going to produce substantial 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", 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 - they 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.
The important point to draw from this discussion is the need for documenting intent and actions taken in the pursuit of profit. This is clearly an example of where the "best offense is the best defense".

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