



Hobby vs Trade or Business

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Rural Tax Education

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 - Disaster/Weather Losses
 - Treatment of Government Payments
 - Farm Losses and Hobby Rules
 - Self-Employment Taxes
 - Estate and Gift Taxes
 - Like Kind Exchanges
 - Depreciation
 - Etc...



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A Business or Not?

- A 15-acre cattle ranching activity
- A Hobby or a Bona Fide Business Venture
- What do you think?
- How to make sure that your venture is looked upon as a business not a hobby

A Business

- If it looks like one, sounds like one, and acts like one, then it must be a business
- Keeping good records is the greatest step to look like a business
- IRS does not require that records be kept in a specific manner (accurate and relevant)
- Make sure that there is an indication of a profit motive and/or business growth



Trade or Business

- Generally, an activity carried on for a livelihood or in good faith to make a profit
 - Facts and circumstances determine whether an activity is a trade or business
 - regularity of the activities and transactions,
 - production of income, and
 - ongoing efforts to further the interests of your business.
- Groetzinger case: Continuity, regularity, and profit motive

Hobby Farming (Internal Revenue Code Section 183)

- Showing several years of losses on the tax return may raise questions
- Must meet the presumption of profit motive:
 - Profit three out of five tax years, or
 - Profit two out of seven tax years (breeding, showing, training, or racing horses)
- Scale of the operation is not necessarily a factor
- You do not need to make a profit to be operating a trade or business, but you do need to have a profit motive

Hobby Farming

Relevant factors that IRS uses for determination (9 items)

1. Manner in which the farmer carries on the farming activity
2. The expertise of the farmer or advisors
3. The time and effort expended
4. Expectation that assets used appreciate in value (productivity)
5. Success of the farmer in other activities
6. History of income and losses
7. The amount of occasional profits earned
8. Financial status of the farmer
9. Elements of personal pleasure or recreation



The Farming Activity

- The business owner operates to make a profit
- Is there a business checking account
- Records need to be kept in a business like manner
- Does a realistic business plan exist (reasonable annual income and expense projections)

Expert Advice

- Seek sound business and technical advice
- Study, take classes, seek professional assistance, and follow the recommendations
- Seek information from similar type business operators and owners

Time and Effort

- Keep track of the amount of time and effort you are expending in the venture
- Important if non-farm employment exists
- Does the amount of time spent indicate a profit motive
- If hiring employees or managers, are they knowledgeable and competent (follow appropriate labor laws)

Business Value Change

- Is the value of the business increasing over time
- Changes in livestock values
- Is the value of land increasing due to improvements (fertility, forage quality, fences, etc.)
- Are profits being plowed back into the business in order for it to grow or improve

Experience

- Have you done anything like this before
- Have you been successful with a similar venture in the past
- Taking a non-profitable venture and making it profitable is a sign of a profit motive

What has been Happening

- Income and loss history
- Are losses due to business start-up
- What is the production timeline
- Are losses due to events that are beyond your control (fire, theft, weather, war, etc.)
- Did market factors change (domestic vs world)
- Keep records to substantiate what occurred and when



Has the Venture Made Money

- What profits have been earned
- Substantial profits that are infrequent may indicate a profit motive
- Are there periods of large or continuing large losses with an occasional small profit
- Have there been reasonable opportunities to earn profits

Other Income Sources

- What is your financial status?
- Is there substantial income from other sources (non-farm income)
- Is the purpose of the venture to create losses to offset other income
- What is your reason for establishing the venture

Are you having fun!

- What is your passion for the venture
- You must enjoy what you are doing
- Is lifestyle driving the venture?
- However, is there a potential for continuing the business without making a profit (would you keep doing this even though it may never make a profit)

Business Start-Up

- In the early years, business has not made a profit for the 3 out of 5-year rule (2 out of 7-year)
- File IRS Form 5213 to obtain a longer period of time to get the business established before the IRS can question it as a hobby
- This is an automatic extension of the examination period during which the profitability might improve

Impact of the 9 Factors

- Not any one factor indicates that a hobby exists
- The responses to all 9 are used to make the determination
- Not meeting the presumption of profit motive:
 - Profit 3 out of 5 tax years, or
 - Profit 2 out of 7 tax years (equine activities)does not mean the business is a hobby but allows the IRS to question the owner

Income Tax Treatment for a Hobby

- Tax treatment of losses vary greatly for hobby
- Profit = Income minus Expenses
- Losses occur when expenses exceed income
- Hobby: losses are given “hobby loss” distinction and expenses in excess of income are disallowed as a deduction
- Business: losses are allowed to offset or reduce other income

Hobby Income and Expenses

- Must report income on the tax return
- Usually deduct ordinary and necessary expenses within certain limits
- Generally, deduct hobby expenses up to the amount of hobby income
- Must itemize deductions on the tax return to deduct hobby expenses (TCJA makes this difficult)
- A hobby loss can't be deducted from other income.

Help to Avoid Hobby Loss Rules

Records allow you to:

- Monitor business progress
- Monitor personal progress
- Prepare financial statements
- Identify sources of income
- Keep track of deductible expenses
- Prepare an accurate tax return
- Support items reported on the tax return
- Current and historic balance sheets

Additional Information to Keep

- What is done to improve your business skills
 - Classes and seminars attended
 - Consultations with business experts
 - Operational changes made to improve profits
- Records of floods, drought, or disease that has impacted business operations

Burden of Proof

- You are responsible for proving entries of income, deductions, and statements made on your tax return
- You must be able to prove this by having the information and receipts plus keeping adequate records
- The 15 acre ranch was a business, scale was not a factor

Good Management Practices

Before starting the business, do the following:

- Accounting
- Legal council
- Consult with cooperative extension specialists

Useful IRS Publications

- Publication 552, Recordkeeping for Individuals
- Publication 583, Starting a Business and Keeping Records
- Publication 463, Travel, Entertainment, Gift, and Car Expenses
- Publication 15, Circular E - Employers Tax Guide
- Publication 225, Farmer's Tax Guide
- Publication 535, Business Expenses

Additional References

- [Rural Tax Website](#)
- www.RuralTax.org - Select Tax Tips

Farm Losses versus Hobby Losses: RTE/2022-05

The End

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Questions and Comments