

TF.7

Intent to Profit and Hobby Losses

In order for expenses to be deductible, the expenses must relate to a trade or business – not a hobby or recreational activity. How is that determined? **The taxpayer must be able to demonstrate that their activities are engaged in with a legitimate intent to profit.** Profit in this case means either annual profits (sales in excess of expenses) or long-term appreciation of assets (assets will later be sold for an amount in excess of cost).

Things that will not meet this test: Gardening, growing food for a food bank, growing food to give away, landscaping to maintain or improve the value of your personal residence, keeping animals or livestock for pleasure or to maintain your personal residence.

If you falsely claim that an activity is a business for the purpose of reducing the income taxes you owe, or increasing your Earned Income Tax Credit, that is a form of tax fraud – this is why the IRS will likely question your fundamental business profit motivation if they audit a tax return that shows farm losses, or an EITC that was increased by farm income or loss.

Demonstrating a Profit Motive

The IRS will look at all facts and circumstances. At a minimum you should be able to show:

1. A plausible plan for generating income
2. That you keep ordinary and necessary business records and use them to make business management decisions
3. That you respond to losses by making changes to the operation
4. That you have and continue to acquire the knowledge appropriate to the needs of the business.

See Pub 225 and RuralTax.org for more information on this topic.

But I was told if I lost money in 3 out of 5 years, it was a hobby and not a business.

The Hobby Loss Rule says that if you lose money in 3 out of 5 years then you must be able to demonstrate, with evidence, that you have a legitimate intent to profit.

It is incorrect to state that if you lose money 3 out of 5 years you are a hobby. Many businesses lose money in 3 out of 5 years.

Normally the IRS must assume that if you file a business tax return (Schedule C or F) you are a legitimate business, or the burden of proof is on the IRS to demonstrate that you do not have a legitimate business. If you have lost money in 3 out of 5 years the burden of proof shifts from the IRS to you – now you have to be the one to prove your legitimate intent.

It is common for people to have an incorrect understanding of this rule - but now you know the real rule. If you have a legitimate business and can demonstrate your legitimate intent to profit you should not hesitate to file Schedule F and take your farm losses against other income.

This resource is derived from materials developed by the University of Arkansas School of Law Agricultural Tax Training as part of the Agricultural Financial, Tax and Asset Protection (AgFTAP) partnership with the University of Arkansas Southern Risk Management Education Center and others.