

# Careful System of Documentation Essential to "Weekend Ranchers"

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*Demographic figures drawn from a continuing survey of new members of the American Angus Assn. clearly illustrate the fact that a large percentage of the organization (and therefore Journal readers, too) can be described as "weekend" or "gentleman" farmers. Of those responding:*

- 65% list their major occupation as something other than farmer or commercial cattleman.
- 77% generate less than half their income through farming.
- 86% earn less than half their income from the registered Angus business.
- 72% have 10 or less registered Angus, and 71% anticipate having a cow herd of 50 head or less five years in the future.

*With these facts in mind, we encourage all Journal readers to study the following article. It covers a few basic points important in preserving the deductibility of farming and ranching operation expenses. Such information is of obvious interest to those who classify themselves as "weekend" farmers, and should also help full-time cattlemen better understand many of their customers.*

Cattle ranching can be undertaken for the pleasure of ranching, as well as for profit. When this is the case, with a rancher who also has another occupation (such as a physician, dentist, attorney or other professional), the Internal Revenue Service (IRS) is quick to attempt to prove that the ranching activity is a hobby, and therefore on a "not-for-profit" basis.

Under this assumption, the IRS will assert the provisions of Section 183 of the Internal Revenue Code, the so-called "Hobby Loss" provisions. This is most frequently asserted against individuals who also have significant amounts of non-agricultural income, often referred to as "weekend farmers" or "gentleman ranchers."

Section 183 is applicable to any activity engaged in by an individual (or an "S corporation") if "the activity is not engaged in for profit." Under this circumstance, the code permits the gentleman rancher to deduct the expenses of operation only if the expenses would be deductible elsewhere in the tax return without regard to the profit motive (interest, property taxes, etc.). It also includes those expenses which would be deductible if the activity were engaged in for profit, but only up to the amount that the gross income from the activity exceeds those deductions allowable elsewhere in the tax return.

In simple terms, the deductions are

generally limited to the amount of gross income derived, thereby causing most of the expenses to be non-deductible. Unfortunately, the fear of loss of the deductibility of these expenses as a result of being declared "hobby losses" by the IRS has caused many city investors and would-be ranchers to avoid, or minimize their agricultural investments. This minimizing of agricultural investments is responsible for a further decline in the availability of new investment capital which is needed by the agricultural industry. Despite the IRS' assertions, the gentleman rancher

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has a very good chance of establishing that the activity is "engaged in for profit" (the burden of proof does rest with the taxpayer) if he observes the following guidelines.

#### **Presumption test**

First, the question of whether or not the profit motive is present may be mitigated entirely through provisions of the code which state that the activity

is presumed to be engaged in for profit, if in two or more years in a given five (consecutive) year period, the gross income exceeds the deductions attributable to the activity. There are very strict requirements for meeting the "presumption" test, and these must not be overlooked. Furthermore, even if the activity meets all the requirements of the presumption test, the IRS may still allege the activity is not profit oriented, provided all of the facts and circumstances of a particular case prove the taxpayer is engaged in a hobby.

Additionally, the IRS may assert that the activity did not remain "substantially the same" during the five-year period. This could be the case where the taxpayer, through the use of such techniques as cash basis accounting, is able to "manage" the earnings such that the enterprise reflects very minimal profits in two years and shows very large losses in the other years of the five-year period. The same effect could occur where the activities of the enterprise are transferred from one business entity to another, such as from a proprietorship to a partnership or corporation.

Even if the "two-year" presumption test is not met, the code specifically provides that the presumption test can only work to show that a profit motive does exist, and not that a profit motive does not exist. Thus, in such a situation, the code can only be used for the

taxpayer, and not *against* the taxpayer. If the presumption test is not met, it means that a different method of proving the activity is engaged in for profit must be used. The regulations provide additional guidance for making this determination through the enumeration of nine relevant factors which are considered in determining if a profit motive exists.

In determining if a profit motive exists, the regulations provide that the determination is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case. Furthermore, they specifically provide that "a reasonable expectation" of profit is not required if the taxpayer can prove that he entered into or continued the activity with the objective of making a profit. Accordingly, if the taxpayer can prove that his *intent* is to make a profit, even if his expectations have been unreasonable, then the hobby loss provisions will not be applied, and the expenses will be allowed as deductible in carrying on a trade or business.

In determining the taxpayer's intent, the regulations provide that all the facts and circumstances surrounding the activity will be taken into account,

and that no one factor will be determinative. They also provide, however, that greater weight will be given to objective facts than to the taxpayer's statement of his intent. The importance of good record-keeping cannot be over-emphasized, since the taxpayer must be able to prove his intent within the guidelines of the nine relevant factors.

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It may well be as simple as "No Documentation—No Deduction."

#### **Manner of activity**

The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. The courts have consistently recognized that serious businessmen maintain adequate accounting records. Furthermore, the code requires all businesses

to maintain adequate records so that their tax liability may be properly reported. The courts recognize that the better the accounting records, the better the taxpayer is prepared to make sound financial and business decisions.

While good accounting records are consistently enumerated as a factor in activities which are determined to be engaged in for profit, the finest accounting records in the world will not, by themselves, prove a profit motive. The IRS will also look to the operation of the activity to ascertain if it is carried on in a businesslike manner. This may be demonstrated where the activity is carried on in a manner substantially the same as other activities of a similar nature which are profitable. Actions which may also be indicative of carrying on the activity in a businesslike manner include changing operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with the intent of improving profitability.

#### **Expertise of taxpayer or advisors**

While the IRS frequently attempts to assert the hobby loss provisions against taxpayers with other occupations, the regulations include provisions which can be used to overcome the assertion.

Preparation for the activity by extensive study of the accepted operational business practices of the activity, or consultation with those who are expert advisors in that activity, may substantiate a profit motive.

The IRS does not require you to be an expert in order to undertake ranching, but the regulations encourage you to consult an expert if you're not, or else study to become an expert. Once this expert knowledge is acquired, it may be indicative of a profit motive to carry on the activity in accordance with practices directed by such expert knowledge. By the same token, when a taxpayer has or seeks such expert knowledge and does not carry on the activity in the manner dictated by that expert knowledge, it may well be held that a profit motive does not exist. Accordingly, when the gentleman rancher gets good, sound, professional advice, he is well advised to follow it.

#### **Taxpayer's time and effort**

The fact that a taxpayer devotes a substantial portion of his personal time and efforts to carrying on an activity may be indicative of a profit motive. This is especially true if the time spent in the activity does not have significant or substantial personal or recreational aspects. If the ranch has abundant wild game on it, and the gentleman rancher is only active in ranching during hunting season, it will be difficult to prove that the ranch is not operated as a hobby. Alternatively, the regulations and the courts have also found the fact a taxpayer does not devote an extensive amount of time to an activity does not necessarily signify that the activity is only a hobby, if the taxpayer employs competent people to carry on the activity in his behalf.

#### **Appreciation in value of assets**

The regulations also provide that the term "profit" encompasses appreciation in the value of assets, such as land, used in the activity. With the recent increases in the value of agricultural land, it may be feasible to contend that a portion of anticipated profitability exists because of the expectation of an increase in the value of the land used in the operation, even if no profit from current operations is realized.

In this respect, however, the taxpayer should be careful in asserting that profitability is entirely dependent on the increase in value of the land in that the IRS can maintain that the taxpayer is actually engaged in two separate activities—ranching and land speculation—thus eliminating the appreciation in

land value from the ranching profit motive test. The regulations include guidance that specifically deals with the appreciation of ranch land, and if this is an integral part of establishing the intent of a gentleman rancher, then these guidelines should be consulted in detail.

#### **Taxpayer's previous successes**

The fact that the taxpayer has engaged in similar activities in the past and has been successful at converting them from unprofitable operations into profitable enterprises may indicate that he is engaged in the activity for profit. The fact that the enterprise is currently unprofitable may also be mitigated by the taxpayer's previous success in a similar situation. It is important to remember that the regulations do not require that the activity actually be profitable, but only that it be entered into with the intent of being profitable. Therefore, if a taxpayer has previous success in a similar situation, it is not unreasonable to expect a similar success in the current activity. (Thus indicating the intent to be profitable.) While the taxpayer's previous successes may be helpful, a lack of previous success will not necessarily be detrimental, particularly if the taxpayer

engages professional expert consultants who provide operational guidance.

#### **Taxpayer's income or loss history**

The IRS realizes that a series of losses during the initial or developmental stages of a business do not necessarily indicate that the activity is not engaged in for profit. If there is a long

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history of unprofitable years, it may well be difficult to establish a profit motive. However, if it can be proved that a profit is still expected, or that the losses were caused by unforeseen or fortuitous circumstances such as drought, fire, flood or depressed market conditions, then even a long history of losses will not necessarily be inter-

preted as a lack of profit motive.

In this respect, a gentleman rancher is well advised to maintain a permanent record of any such circumstances which affect a given tax year, since a written log of such unforeseen circumstances would normally be more weighty in the determination than the taxpayer's mere recollection of those circumstances. Needless to say, a series of years with net income would present strong evidence that the activity is engaged in for profit.

A recent court case extends the concept of losses in formative years with an intention of a later profitable level of operations even farther, and is worthy of mentioning here. The 7th Circuit Court of Appeals, in reversing a Tax Court decision, significantly broadened the profit motive in that it allowed that the petitioners need only prove their current actions were motivated by the expectation they would later reap a profit, which, in this case, was when they finished renovating the farm and began full-time operations. This was a period expected to require about 10 years.

In reversing the Tax Court, the appellate court disagreed with the lower court's perspective that the taxpayer

needed to believe that they could expect to realize a profit "from their current level of activity" at the farm. Under the concept of this decision, a gentleman rancher may be able to avoid the hobby loss limitation by proving that his current actions are motivated by the expectation of a future profit instead of an immediate profit.

#### **Amount of occasional profits**

The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may prove to be useful in evaluating the taxpayer's intent to earn a profit. An occasional small profit from an activity which consistently generates large losses, or from an activity where the taxpayer has made a substantial investment, might tend to indicate that the activity is not engaged in for profit. On the other hand, the possibility of substantial profit, even though remote or occasional, would generally be indicative that the activity is not entered into as a hobby. The possibility of a substantial profit in a speculative activity is generally sufficient to indicate a profit motive even though losses or only occasional small profits are actually generated.

#### **Financial status**

The taxpayer's financial status is frequently evaluated in conjunction with the determination, especially when the taxpayer has invested in an agricultural syndicate. Because there frequently are tax advantages to agricultural investments, the IRS insists that economic profit, and not just after-tax profit, is the motive when the investment is made. The regulations address this problem

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by stating that substantial income from sources other than the activity may indicate that the activity is not engaged in for profit, particularly if the losses from the activity generate substantial tax benefits and/or if there are substantial personal or recreational elements involved.

One court went as far as to say that this regulation merely makes the point that the expectation of having the tax

collector share in the cost of a hobby might induce an investment in such a hobby which might not otherwise be made. In decisions which show the same clear understanding of the problem, the courts have consistently held that "taxpayers who are relatively poor would not intentionally try to lose money," and therefore, a "lesser" economic status is generally indicative that an activity is engaged in for profit.

#### **Recreational and personal pleasure**

The regulations also address activities which generate significant personal pleasure to the taxpayer. They specifically state "the presence of personal motives in carrying on an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved." This position is softened somewhat by regulations which state that the fact that the taxpayer derives pleasure from the activity is not sufficient to indicate the activity is not engaged in for profit if other factors indicate that the activity is, in fact, profit oriented. The courts have generally construed this to mean that the activity is considered to be a hobby if the primary motive is "fun."

In taking a position contrary to the

IRS, however, one court stated that a "business will not be turned into a hobby merely because the owner finds it pleasurable; suffering has never been made a prerequisite to deductibility." While the gentleman rancher will hopefully find pleasure in his ranching activities, he should be well aware that the IRS may seek to eliminate the deductibility of his losses based on that pleasure.

### **In summary**

In order to avoid the imposition of the hobby loss provisions, the gentleman rancher must prove that his intent is to earn a profit. To accomplish this, the taxpayer must use all of the facts and circumstances surrounding his particular ranching activity. The regulations are explicit in stating that no single factor is determinative, and yet the taxpayer may be able to convincingly establish that the activity is profit oriented by establishing only two or three of the relevant factors. It is also important to keep in mind the courts consider all facts and circumstances relative to the activity in an objective manner.

While no one factor seems to be of overwhelming influence, the factors which seem to be most commonly present when an activity is found to be engaged in for profit are:

- The taxpayer and/or his advisors have expertise in agriculture and ranching;
- The taxpayer devotes a significant amount of time to the ranching activity;
- The ranching activity is carried on in a businesslike manner; and
- The taxpayer has a legitimate expectation that the underlying assets used in the ranching activity will appreciate in value.

With these factors in mind, and with a careful system of documentation, the gentleman rancher should have a sound opportunity to preserve the deductibility of his ranching operation expenses.

*The information contained in this article is intentionally broad in scope in order to be of generalized interest. Because of the complexities of how these items might relate to a specific individual's tax circumstances, no representation is made as to either the accuracy or applicability of the information inasmuch as it relates to any individual's tax position or planning. If it appears that any of these items might apply to an individual's return, that individual is encouraged to seek competent tax advice.* AJ

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