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Issue Contents

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Passing Hobby Loss Test Does Not Insure Deductibility of Ranch Losses

by Robert P. Achenbach, Jr.*

In the great majority of cases[1] involving the deduction of hobby losses, a holding that the taxpayer proved an intent to make a profit determined that losses from a farm or ranch were deductible against other income. In a recent Tax Court case,[2] the taxpayers discovered that compliance with the hobby loss rules did not guarantee deductibility of their substantial ranching losses.

The Case Facts

The taxpayers were husband and wife who were a computer science advisor and a retired physical therapist. In 1999, the couple purchased over 500 acres of rural ranch land in Utah which was in poor condition. The taxpayers formed a two-member LLC to operate the ranch and the LLC reported income and expenses on Schedule F in conjunction with Form 1065, *U.S. Return of Partnership Income*. The taxpayers reported the pass-through losses from 2000 until 2015 on Schedule E, and in 2013 through 2015, the losses were decreasing each year. The case involved only tax years 2010 through 2014. Initially the taxpayers used the property for raising horses but quickly changed to raising cattle in 2000. The taxpayers hired a ranch manager and a ranch hand and hired a CPA to prepare the tax returns for the LLC and the taxpayers.

The taxpayers did not maintain contemporaneous records of their time spent on the ranch activity but presented an activity log created for trial, claiming over 1500 hours of management activity by the husband and 800 hours by the wife in each year involved in the case. Additional facts are discussed below with each hobby loss factor.

I.R.C. § 183 and Hobby Losses

I.R.C. § 183 disallows deductions against other income for losses in excess of revenues from activities not engaged in for profit. Treas. Reg. § 1.183-2 provides nine factors to be used to determine whether an activity is engaged in for profit: (1) the manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profits earned, if any; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation were involved.

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Court Analysis of the Hobby Loss Factors

The court held that the taxpayers operated the cattle ranch with the intent to make a profit based on the nine factors of Treas. Reg. § 1.183-2 as follows:

(1) Although the court noted that the taxpayers did not have a written business plan and failed to maintain records sufficient to make business decisions, the taxpayers made significant efforts to reduce expenses and operations that demonstrated that the taxpayers made informed decisions to increase profits; thus, this factor favored the taxpayers.

(2) The court found that the taxpayers consulted with experts in several aspects of cattle ranching; therefore, this factor favored the taxpayers.

(3) The court found that the taxpayers hired a ranch manager and ranch hand to work the ranch and hired a veterinarian to assist with managing the effects of high altitude on cattle; therefore, this factor favored the taxpayers. However, see the discussion below as to the taxpayers' material participation in the activity.

(4) The court held that this factor was neutral because the taxpayers did not provide evidence of the value of the ranch to determine whether they had a reasonable expectation that the property would appreciate in value.

(5) This factor was not discussed.

(6) The court held that the taxpayers' history of only losses, sometimes significant losses, was a strong factor against the taxpayers.

(7) This factor was not discussed, although the evidence showed that the taxpayers never earned a profit from the activity.

(8) The court found that the taxpayers were able to offset the years of losses against significant income from other sources; therefore, this factor did not favor the taxpayers.

(9) This factor was not discussed.

Court Analysis of the Passive Activity Loss Issue

Under I.R.C. § 469, loss deductions from a passive activity are generally allowed for the years in which the losses are sustained only to the extent of passive activity income.[3] In general, a passive activity is a trade or business in which the taxpayer does not materially participate.[4] A taxpayer materially participates in an activity when the taxpayer is involved on a regular, continuous, and substantial basis.[5] A taxpayer can establish material participation by satisfying any one of seven tests provided in the regulations.[6] In this case, the court focused on two of the tests most relevant to the case: (1) the taxpayer participated in the activity for more than 500 hours during such year or (2) based on all of the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis during such year.[7] A taxpayer's participation in the management of an activity is not taken into account in applying the facts and circumstances test if a paid manager participates in the activity, and no individual performs services in connection with the management of the activity that exceeds (by time) the amount of services performed by the taxpayer.[8]

In discussing the first test, the court found that the taxpayers provided an annual activity log with only estimates of their time spent on the activity, created only in preparation for trial, including payroll and bill payments, meetings with employees and hiring and firing of employees. In addition, the taxpayers submitted minutes of weekly meetings, by phone and in person, with the ranch manager and ranch hand. However, none of the records listed the amount of time spent on each activity. Without some evidence of the time spent by the taxpayers, the court court held that it could not determine whether the taxpayers met the 500 hour requirement.

As to the second test, the court held that the taxpayers did not meet the facts and circumstances test of the regulations because they hired a ranch manager and failed to provide evidence that the taxpayers spent more time on the ranch management than the ranch manager. Thus, the court held that the losses were passive activity losses and could be claimed only as an offset of passive activity income.

Conclusion

Note that in other tax areas, such as special use valuation[9] and installment payment of estate tax,[10] it is possible to achieve material participation despite the presence of a paid manager or agent, such as a farm manager or even to achieve material participation through an agent. However, the passive activity loss rule seemingly makes an individual's own involvement in management immaterial where a paid manager is involved. Thus, an investor in a cattle feeding venture who merely approves or disapproves proposed actions or decisions by the manager or managing partner of the cattle feeding venture is not considered to be materially participating.[11]

For over 30 years, the author has read and reported on many dozens of hobby loss cases involving farms and ranches and this is the first known case where the taxpayer met the hobby loss rules for deductibility of losses only to have those losses disallowed under the passive activity loss rules. Although most hobby loss cases rarely turn on the third factor of the hobby loss regulations, that factor may be an unexpected hazard for taxpayers who focus solely on meeting the other eight factors. Taxpayers would be well advised not only to participate in the farm or ranch activity itself but also to keep full and accurate contemporaneous records of their management activity in addition to the records of all business activity to support reported income and deductions.

ENDNOTES

[1] See Harl, *Agricultural Law*, § 30.06 (2018) and Harl, *Farm Income Tax Manual*, § 4.07 (2018) for discussions of the hobby loss rules.

[2] Robison v. Comm'r, T.C. Memo. 2018-88.

[3] I.R.C. § 469(a)(1)(A), (d)(1). See Harl, *Agricultural Law*, § 30.08 (2018) and Harl, *Farm Income Tax Manual*, § 4.08 (2018) for discussions of passive activity losses.

[4] I.R.C. § 469(c)(1).

[5] I.R.C. § 469(h)(1).

[6] Temp. Treas. Reg. § 1.469-5T(a).

[7] Temp. Treas. Reg. § 1.469-5T(a).

[8] Temp. Treas. Reg. § 1.469-5T(b)(2)(ii)(A).

[9] See Treas. Reg. § 20.2032A-3(g), ex. 4.

[10] I.R.C. § 6166.

[11] Temp. Treas. Reg. § 1.469-5T(k), Ex. 8 (manager received compensation).