Agricultural Law Press
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Agricultural
Law Digest

Volume 29, No. 8 April 20, 2018 ISSN 1051-2780

What Does It Take To Be Conducting a Ranching Activity for Profit?

-by Robert P. Achenbach, Jr.* and Neil E. Harl**

That sounds like a question with a hundred answers—freedom from disease, low cattle prices, low calving rate, interference with pregnancies or failure of fences along highways, to name the obvious ones. But failure to conduct the ranching activity in a "business-like manner"? Surely not. And being called on the carpet for failure to run a herd of cows profitably? That sounds like the last worry a rancher should expect. But David Williams, a rancher in a rural area near a small Texas town ran up against just that –by a highly critical IRS agent, and lost.[1] One wonders how an IRS agent could be tripped up by such a situation.

The Facts

The taxpayer, a former chiropractor, owned and operated a profitable research and publishing business and an unsuccessful retail gun shop. After the taxpayer sold the chiropractic practice, the taxpayer decided to live in the country and purchased over 1,138 acres of ranch land in Texas. Although the property was primarily purchased for a residence and office for the other businesses, the taxpayer also decided to run a feeder stocker cattle operation on the property. The taxpayer hired two workers, one to repair and improve the fences and buildings and one to take care of the cattle. The taxpayer also hired a bookkeeper to manage the records of all three business activities. The taxpayer hired a CPA to prepare the tax returns for all three businesses, including Schedules F for the cattle operation.

The cattle operation, as reported on Schedule F, showed losses each year from 2000 through 2015. This case, however, involved only the years 2011 and 2012, although the court also examined evidence from 2013, 2014 and 2015. The taxpayer provided no evidence of a written business plan; however, in 2013, the taxpayer changed to a cow/calf operation because of the poor condition of the fences.

Section 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 advisors;

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(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.

The court also cited a Fifth Circuit Court of Appeals (the court to which this case could be appealed) case, Westbrook v. Comm'r, 68 F.3d 868 (5th Cir. 1995), aff'g, T.C. Memo. 1993-634, which stated that ". . . a taxpayer must establish that he engaged in the activity with the primary purpose and intent of realizing an economic profit independent of tax savings."

Court's Analysis

The court found that seven of the factors favored the IRS position denying the loss deduction, one factor favored the taxpayer and one was neutral, as discussed below.

(1) The court found that the taxpayer did not operate the activity in a businesslike manner because, although the taxpayer kept separate records using an outside bookkeeper, the taxpayer did not present evidence of any use of those records to analyze and change the activity to make it more likely to be profitable. The court emphasized that the taxpayer had not made any changes to the operation until the fifth year when the taxpayer hired a ranch hand and the 13th year when the taxpayer changed to the cow/calf operation. There is no discussion, however, of the status of the operation in 2010 and 2011, both of which indicated that, although no sales were made, the taxpayer had reduced expenses compared to the prior 10 years.

(2) The court found that the taxpayer did not have any formal education in animal husbandry (although the facts did show that the taxpayer grew up on a cattle ranch) and did not seek expert advice about running a cattle operation, except for informal discussions with family and neighbors.

(3) The taxpayer conceded that the taxpayer spent only six to eight hours per week on the cattle activity but argued that the two ranch hands provided the working time on the activity. The court discounted the use of workers because the taxpayer did not provide evidence of the workers' competence; thus the court found that this factor weighed against the taxpayer.

(4) The fourth factor, evidence of appreciation of value, was the only factor found to be neutral by the court. The court found no evidence that the taxpayer expected the property to appreciate in value because the taxpayer failed to provide evidence of the adjusted basis of the property involved. The court appeared to have ignored the improvements to the property made by the ranch workers, including new buildings and fences.

(5) The court acknowledged that the taxpayer had created a successful research and publishing business but found that business too unrelated to ranching to support a finding that the taxpayer had a history of running profitable businesses.

(6) and (7) The court found that the cattle activity had only losses and no years of profits.

(8) The court found that the taxpayer had substantial income from the research and publishing business which was offset by the losses from the cattle activity.

(9) The only factor which the court found in favor of the taxpayer was in finding that the taxpayer received no personal pleasure from the cattle activity.

Thus, the court held that the taxpayer did not operate the cattle activity in 2011 and 2012 with an intent to make a profit and disallowed the deduction of losses from the cattle operation for those years.

In Conclusion

The case is notable for the lack of discussion of the nature of cattle ranching in the geographic area and industry as a whole. The court overlooked the drought in the Texas Panhandle, drooping prices, the fact that the farming operation produced gross revenues from the cattle herd in several years. The court noted ". . . the creek beds were full of gravel and the springs were not running" as though something could be done about lack of water in arid Texas.

Although much progress has been made in the past century to emphasize the need for farmers and ranchers to be aware of the tax and financial ramifications of nearly everything that happens on a farm or ranch, some still treat the "business" of farming and ranching too casually. Perhaps the taxpayer's main error in this case was the reliance on the CPA who failed to raise red flags after the first five years of operation that the IRS would challenge the loss deductions unless the taxpayer realized some taxable income quickly. The evidence showed that the taxpayer had minimal revenue from the activity for 2006 through 2015 and any CPA worth the fee should have pointed out the audit danger. The case gives no indication that the taxpayer received any such advice.

ENDNOTES

[1] T.C. Memo. 2018-48. See Harl, *Agricultural Law*, § 30.06 (2018) for discussion of hobby losses. However, it can be argued that the taxpayer's cattle activity was not a "hobby." See 2 Harl, *Farm Income Tax Manual* § 4.07 (2017)