Worried about Being Classified a Hobby Farm by the IRS? What You Need to Know.

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Perhaps your farm is in its early years, in the middle of a significant transition, or just muddling along year after year. If you've piled up a few years of losses, it's easy to wonder whether the IRS or your state will view your farm as a **hobby and not a business** and deny you the ability to deduct your legitimate business losses.

The good news? The IRS understands that farming, like any other business, will have its ups and downs. While you don't need to be in the black every year to be considered a legitimate business, you do need to show you're operating with the **intent of making a profit.**

Here's what you need to know about how the IRS handles the hobby loss question.

Hobby or Business? Why it Matters.

If the IRS classifies your farm as a **business**, you can:

- Deduct all legitimate farm expenses even if they exceed income.
- Offset farm losses against other income (wages, investments, rental income, etc.).
- Carry forward losses to future years.

If your farm is classified as a **hobby**, you **cannot:**

- Deduct expenses beyond the amount of farm income. You can't use farm losses to reduce other taxable income.
- Create a net loss meaning your expenses can bring down your farm income to $0 but no further.
- Carry losses forward to future years.

The 3/5 Rule: A Safe Harbor, not a Hard Rule

A common misconception is that you must turn a profit within a few years to avoid the "hobby" label. That's actually not true—but there is a guideline that helps:

If your farm shows a profit in at least 3 of the last 5 years (or 2 of 7 for horse breeding), the IRS **generally presumes** it's a business.

Failing the 3/5 rule doesn't automatically mean the farm is a hobby. It just means the **burden of proof shifts to you** to demonstrate that you are running the farm with a profit motive.

Many legitimate farm businesses go through unprofitable stretches, especially in the early years or when changing business models. If your previous income stream dries up during your pivot, that doesn't mean the IRS will suddenly call it a hobby– you just need the paper trail to show you're still serious about making a profit.

How to Prove Profit Motive: The 9 IRS Factors

The IRS doesn't just look at whether you made money. They consider **nine factors** when determining if your farm is a business.

- **Manner of operation** – Are you keeping records, tracking income and expenses, and running things like a real business?
- **Expertise of the taxpayer** – Do you have the experience and training required to succeed? Are you seeking professional advice or guidance on how to become profitable?
- **Time & effort spent** – Are you putting in enough work to show this is a legitimate business pursuit?
- **Expectation of asset appreciation** – This is key! Even if yearly profits are low, if your land, livestock genetics, or other assets are increasing in value due to your efforts, that supports a profit motive.
- **Past successes** – Have you run a successful business before? Turned around another farm or venture? That works in your favor.

- **History of income & losses** – Are there at least some profitable years? A bunch of losses piled up in a row may be frustrating, but profit at some point helps your cause with the IRS.
- **Size of profits or losses** – Are you taking steps to reduce losses and move toward profitability?
- **Financial status of the taxpayer** – If you have a high-paying off-farm job, the IRS may scrutinize whether farming is a side pursuit rather than a business.
- **Personal enjoyment** – If it looks more like a lifestyle than a business, the IRS may question intent. (But enjoying the work doesn't automatically make it a hobby!)

No single factor is determinative. The IRS looks at the big picture. Even if your farm hasn't turned a profit yet, showing you're operating strategically and with business intent goes a long way.

What Farmers Should Do?

If you're in a stretch of losses, don't panic. You can protect your ability to deduct farm losses by:

- **Keeping good records** – Document income, expenses, business plans, and steps you're taking to improve profitability.
- **Filing taxes correctly** – Report farm income and expenses on Schedule F (Profit or Loss from Farming).
- **Maintain a public presence** – Demonstrate efforts to sell and promote your products, through local sales channels or social media profiles.
- **Documenting asset appreciation** – If your farmland, livestock, or orchard is growing in value, track that – it's part of the long-term profit story.
- **Getting professional advice** – A tax or financial advisor can help position your farm as a legitimate business.

Ok, What If the IRS or State Challenges Your Deductions?

If the IRS or your state regulatory agency questions your farm deductions, they'll handle this in three different ways. Here's what to expect, from most common to least common:

- **Most Common:** Correspondence Audit – A letter requesting receipts, financial records, or explanations. Typically, you have 30 days to respond.
- **Less Common:** Office or Field Audit – If needed, the IRS may ask for an in-person meeting or even visit the farm. This is more in-depth, but it's still manageable with good records.
- **Worst-Case: Tax Court** – Rare, but if the IRS denies deductions and you disagree, you can appeal or go to Tax Court. Cases rarely get to this step.

What to Do If You Get an Audit Letter

- **Don't panic** – Most audits are just routine verification requests.
- **Read carefully** – Understand which deductions are being questioned and what documents are needed.
- **Gather records** – Receipts, logs, bank statements, and business plans help support your case.
- **Respond on time** – Typically, you have 30 days to reply, but extensions can be requested.
- **Keep it simple** – Provide what they ask for, nothing extra.
- **Consult a tax professional** – If unsure, an advisor can help craft a response.

Bottom Line

The IRS understands that farming isn't always profitable—but intent matters. The 3/5 rule is helpful, but not required, and even farms that don't meet it can still qualify as businesses if they're run strategically.

If you want to protect your tax deductions, the key is to operate like a business, document your efforts, and stay focused on profitability – all good things you should be doing anyway!

Resources:
https://www.irs.gov/newsroom/heres-how-to-tell-the-difference-between-a-hobby-and-a-business-for-tax-purposes