

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 0-234-674-176
)	
Petitioners.)	DECISION
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(Petitioners) protested the Notice of Deficiency Determination dated March 11, 2021. Petitioners disagree with the Income Tax Audit Bureau’s (Bureau) determination that their farm activity was not for profit. The Tax Commission reviewed the matter and for the reasons stated below modifies the Notice of Deficiency Determination.

BACKGROUND

In the early 1980s, Petitioners acquired property in Idaho. Petitioners initially leased 50 acres of the property for growing hay. In 1987, Petitioners moved onto the property, built a house and barn, and took over the hay growing operation. Over the years, Petitioners began and stopped various livestock raising activities. Petitioners raised hogs, sheep, milk cows, and draft horses. They also grew produce crops and raised chickens for eggs.

As early as tax year 2000 and for several years prior, if not all the way back to 1987, Petitioners reported a loss from their farming activity. The Bureau selected Petitioners’ 2016 through 2018 income tax returns to examine the farm activity, its associated net operating loss carryforward, and bonus depreciation. The Bureau later expanded its review to include tax year 2019.

The Bureau contacted Petitioners informing them about the audit of their farming activity. The Bureau asked Petitioners to complete a questionnaire and to provide documentation for the expenses claimed. Petitioners completed the questionnaire and provided copies of various ads, brochures, newsletters, memberships, a list of investments in the farm, and their business plan.

Petitioners also provided copies of their documentation of the expenses of the farm for tax year 2016.

The Bureau reviewed the information and documentation Petitioners provided and determined the farm activity was not for profit. The Bureau based its determination on an analysis of the relevant factors found in the Treasury Regulations. See Treas. Reg. section 1.183-2(b). The Bureau found because the activity has a history of generating losses for the past 23 years, because no financial projections or analysis was made, because Petitioners expanded instead of narrowing the specialty to reduce costs, and because Petitioners had significant income from other sources and therefore not reliant on the farm, that the farm activity was not for profit. The Bureau disallowed the activity on Petitioners' returns, and as a result of the disallowed activity, the Bureau also adjusted Petitioners' net operating loss carryforward, capital loss carryover, and bonus depreciation additions and subtractions. The Bureau sent Petitioners a Notice of Deficiency Determination that they protested.

Petitioners disagree that their farm/ranch activity, _____ is not engaged in for profit. Petitioners also disagree with the other resulting adjustments stemming from the not-for-profit determination. Petitioners provided their own analysis of the relevant factors countering each of the assertions made by the Bureau. Petitioners summed up their position by stating that the Bureau refused to evaluate their situation without bias. The Bureau only used the facts in Petitioners' response that fit the case the Bureau was trying to make. Petitioners stated the facts that worked in their favor were left out in the Bureau's analysis. Petitioners argue that there is no rule that you have to be a shrewd and proficient businessperson to be profit driven. They argue that one only has to take certain steps to try and become profitable and have an actual and honest expectation of making a profit. Petitioners stated through their multiple iterations of trying different livestock and their most recent plan to teach homesteading skills, they are making every effort to make the farm/ranch profitable.

The Bureau acknowledged Petitioners' protest and referred the matter to the Tax Commission's Appeals Unit (Appeals). Appeals reviewed the matter and sent Petitioners a letter explaining the options available for redetermining a Notice of Deficiency Determination. Petitioners initially wanted to only provide additional documentation. Petitioners provided that documentation which included an affidavit from Mrs. [redacted] with copies of electric bills showing how they were divided between the farm and Petitioners' personal residence, profit and loss statements of their activities for the years involved, schedules of repairs and maintenance expenses, and a list of equipment used on the farm. Appeals reviewed this information and had several conversations with Petitioners' representative (Representative). Throughout this process questions were asked, additional documentation was provided, and more information was obtained. However, at the end of the day, an agreement could not be reached, so Representative requested an informal hearing to present Petitioners' position to the Commission.

A hearing was scheduled for November 7, 2023. Present at the hearing were Petitioners' representative, Commissioner [redacted] and [redacted] Tax Appeals Specialist. Representative began by giving some historical background of Petitioners and their farming activity. Petitioners purchased the farm property in 1983. Over the next four years, Petitioners leased 50 acres for growing hay until they moved to the land in 1987. In 1987 Petitioners started building their house and barn on the land, they also took over the hay growing operation which continues today for feed for their livestock.

In 1990, Petitioners began raising hogs from farrow to finish. They raised hogs through 1996, shipping at their peak 80 to 120 hogs per week. In 1996, Petitioners decided to discontinue their hog operation after reading market predictions. By the fall of 1996 Petitioners shipped their last hog. Petitioners claimed to have had a net profit in 1996. By 1999, the hog market was in shambles.

December 1998 has been dubbed the great hog price wreck which saw prices drop to their lowest point since 1964.

While ramping up their hog production, Petitioners started raising sheep in 1992. They continued this operation until 2018 growing their production to a peak of 25 to 30 market lambs per year. Petitioners decided to discontinue the sheep operation after battles with disease, death, and predators prevented the operation from being as profitable as they projected.

In addition to the hogs and sheep, Petitioners started raising draft horses, the draft horse, in 1995. They purchased breeding mares for several years through 2000 and sold several foals before the recession in 2008. draft horse,

possesses extraordinary upside in both their demand and potential price. Representative stated it is not uncommon for these types of horses to sell for more than \$10,000 each. However, when the market crashed and the recession decimated prices, these once historically safer investments became unmarketable liabilities when the "Kill Floor" was removed and feed costs skyrocketed. During this time, Petitioners could not give their horses away. Nevertheless, Petitioners suffered through because of their desire to maintain and grow the breed.

In 1998, Petitioners purchased their first Guernsey cow to start a small dairy herd. Petitioners' plan was to sell young Guernsey heifers for family milk cows as well as making cheese to sell. Petitioners kept that cow's daughters over the years and sold their offspring as market steers to local customers. During the first 5-10 years Petitioners had some issues building their stock, losing cows to disease and other health issues. The cows would have 1-2 offspring a year and then die off. Petitioners are working toward getting a Small Herd Exemption so they can sell dairy products for human consumption. In 2017, they saw an opportunity to start breeding heifers to sell as personal family cows and changed their cow operation to take advantage.

In 2017, Petitioners hired their son and daughter-in-law to improve the horse operation, and to help improve operations and efficiency across the entire farm. Their daughter-in-law's degrees in horse business management and horse related activities have been invaluable in improving the horses' bloodlines, streamlining the draft horse herd, and updating the horse infrastructure. Petitioners believe they will do better in sales in coming years due to better management of horses and better assessment of the cattle endeavor.

In addition to the livestock, Petitioners grew produce and raised chickens for eggs. To sum it up, Petitioners sell horses, breeding services, beef, eggs, produce and hopefully milk and cheese when they get their small herd exemption for raw milk sales.

Representative continued by discussing the relevant factors found in Treas. Reg. section 1.183-2(b). Each of the factors is discussed later in this decision. Representative emphasized that the regulations indicate that a reasonable expectation of profit is not required, but that the facts and circumstances must demonstrate that there was an objective of making a profit. Representative stated case law echoes this sentiment, stating that the taxpayer need not show a realistic expectation of profit but only an actual, honest expectation.

Representative argued, Petitioners' losses over the years were due to a combination of bad luck, market conditions, predators, disease and illnesses, the recession, and non-producing livestock. Representative stated these were factors outside of Petitioners' control and the resulting losses should not be indicative of the activity's profit objective. Representative stated the regulations even provide for such circumstances citing Treas. Reg. section 1.183-2(b)(6), "if losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease... or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit."

A lot of time was spent on discussing Petitioners' years and years of losses from the activity. A major concern was that the activity never generated enough revenue to overcome its yearly expenses. If it were not for Petitioners' passive income, the activity could not have been sustained. Representative acknowledged this fact, nevertheless, he continued with the argument that Petitioners truly believed they could make the farm profitable. That Petitioners believed the is the draft horse for the country and that they are in the process of building brand awareness to bring the horse into the limelight. Representative stated the overall spirit of the not-for-profit rules is to look at the taxpayer's true intent and purpose. And, although Petitioners have not had much success, they have morphed the farm over the years with the intention of making it profitable. Representative asked that the Tax Commission keep an open mind.

LAW AND ANALYSIS

Internal Revenue Code (IRC) section 162 provides for the deduction of all the ordinary and necessary expenses paid or incurred in carrying on a trade or business. IRC section 183 states that if an activity is not engaged in for profit (commonly referred to as a hobby), no deduction attributable to such activity shall be allowed. The difference between a hobby and a business can be slight, yet the difference is important because the IRC treats hobbies and businesses differently. Generally, a trade or business is an activity carried on to create a livelihood or to make a profit. A hobby, on the other hand, is an activity pursued because of an interest or for pleasure and its primary purpose is not as an income producing occupation. Whether an activity is a trade or business depends on each situation's facts and circumstances.

IRC section 183 contains a presumption that if the gross income derived from an activity for three or more years of a consecutive five taxable years which ends with the taxable year exceeds the deductions attributable to such activity, then, unless the Secretary establishes to the contrary, such

activity shall be presumed for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the number of years is two out of seven.

Treasury Regulations 1.183-2(b) provides a list of relevant factors to be reviewed in determining whether an activity is engaged in for profit; no one factor is determinative in making the determination. The factors include: (1) the manner in which the taxpayer carries on the activity, (2) the expertise of the taxpayer or his advisors, (3) the time and effort expended by the taxpayer in carrying on the activity, (4) expectation that assets used in 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 losses with respect to the activity, (7) the amount of occasional profits, (8) the financial status of the taxpayer, and (9) elements of personal pleasure or recreation.

The Bureau in its determination and Petitioners in their protest both went through the factors to support their determination or their argument. In the Bureau's review of the factors, it determined Petitioners farming activity was not engaged in for profit. The Bureau found that Petitioners had an "extravagant" business plan for expanding the activity but provided no revenue projections as to when the activity would be profitable. The Bureau found Petitioners did keep their books and records using accounting software but made little effort to separate business and personal expenses. The Bureau found that Petitioners' advertising was more educational and informational rather than attempts at selling goods or a product. The expertise of Petitioners or their advisors the Bureau found lacking. According to the Bureau, Petitioners used a "learn as you go" approach, with the exception of raising hogs. The Bureau saw that with every activity other than the hogs, Petitioners acquired a few livestock and then began learning to grow them to be profitable. The Bureau did not find any fault with the time Petitioners put into the activity, other than they were raising several types of livestock which afforded

them little time to concentrate on a specific animal. The expectation that the assets used in the activity would appreciate was found by the Bureau to not be part of Petitioners' plan. Petitioners were not planning to take the profits from selling the property but rather pass it down to their children. It was also determined that the sale of all the livestock would not erase Petitioners' accumulated losses. The Bureau cited Petitioners' hog activity as being a successful activity of Petitioners, however, that was the only activity cited and it may have been for only one year. As for Petitioners' history of profits from the activity, the Bureau researched the Tax Commission's records and found no profit as far back as 1997. From 1997 to 2019, Petitioners reported \$96,408 of revenue from the activity, \$1,976,015 of expenses resulting in accumulated losses of \$1,879,607. To cover these losses, the Bureau found Petitioners had significant income from other sources and that these losses generated significant tax savings for Petitioners. As for the factor relating to recreation and pleasure, the Bureau found that the activity afforded Petitioners a desired lifestyle and the opportunity to own a draft horse while preserving and growing the breed. As a result of its analysis, the Bureau found Petitioners' activity was not for profit.

On the other hand, Petitioners argued the Bureau slanted the analysis to fit its objective rather than objectively looking at all facts and circumstances of their operation. Petitioners stated their business plan is constantly evolving in an effort to be profitable. Petitioners believed they maintained complete and accurate books and records and that they kept personal expenses personal and business expenses business. Petitioners stated they consulted with professionals in the industry and modeled their operations after the industry leaders. They argued, however, that modeling an operation after the most profitable in the industry does not guarantee profitability. Market timing and other outside factors are often the leading causes for low revenue. Petitioners stated their expertise began in the late 1970s when Mr. [redacted] was training to run his own farm. He worked for a farmer doing fieldwork

and other odd jobs around the farm from 1974 to 1978. Petitioners stated they consulted with numerous professionals on operations, scaling, and techniques for each type of livestock. They researched, attended classes, and pursued expertise in raising sheep. They researched how other draft horse breeders have built their successful and profitable businesses and argued that horse breeding can take a long time to develop breed awareness but has very high returns. Petitioners stated they spend almost all of their waking hours on farm operations. The time spent on specific activities varies as they have eliminated activities deemed to have low potential. Petitioners argued that because there is a lack of profitability, they made the business decision not to employ others during the years in question, showing a profit motivated business decision. Petitioners stated the assets used in the business that appreciated in value are the livestock and real property. Petitioners argued the land alone has appreciated to an estimated \$2,600,000, greatly outweighing the accumulated losses from the activity. Petitioners point to their hog raising as being profitable. They also point out that their awareness to evaluate the likelihood of success and their willingness to adapt and change direction, if necessary, indicates their profit motive. Addressing their history of profits and losses, Petitioners stated the farm has not been profitable but there are justifiable reasons and circumstances outside of their control that have contributed to the losses incurred. Petitioners stated the income from the farm has been agricultural, but they are looking into rental and service income in the future for those who want to learn homesteading skills. Petitioners do not deny they have significant passive income. This allows them to devote all their time toward making the farm profitable. As for the farm being pleasurable and recreational, Petitioners argued there is little pleasure in raising hogs, sheep, and cattle. They chose the draft horse because of the breed not for pleasure riding. Petitioners argued there is no rule stating that you have to be a shrewd and proficient businessperson in order to be profit driven. The rule is that you have to take steps to try to become profitable and have an actual and

honest expectation to be profitable.

The Tax Commission reviewed all the documentation and information Petitioners provided and how it all fit in a review of the relevant factors for determining if an activity was for profit or not for profit. The following are some of the observations the Tax Commission made from the information provided.

The manner in which the activity is run Petitioners account for all their expenses utilizing computer software. They made an effort to keep personal and business expenses separate, however, this was not done in every instance. Petitioners' documentation was not easily reconciled with their income tax return. The account information provided was by vendor rather than general ledger accounts and Petitioners did not provide the detail for the amounts claimed on their return. Petitioners accounted for the various activities of the farm separately to determine profit or loss from the activity; however, in their determination Petitioners did not account for any of the common expenses of the farm or overhead. By not including those expenses, Petitioners were not getting a true picture of the profitability or lack thereof of the activity.

The expertise of Petitioners and their advisors: Mr. had a few years of experience doing fieldwork and odd jobs on a farm in the late 1970's. Mr. expertise and training, however, was as a diesel mechanic. Petitioners stated they sought out professionals and industry leaders but failed to show what information and knowledge was imparted. Petitioners stated they have since hired their daughter-in-law who graduated from an equine college. This shows someone with knowledge but probably not much experience, plus this was done after the years in question.

Time and effort expended on the activity: There is little doubt Petitioners spend most if not all their time working the farm. Petitioners did not need to pursue other sources of income due to significant passive income sources.

Assets that appreciate in value: Of the assets with value, Petitioners have real property and real property improvements. Petitioners also have livestock (horses) that could increase in value. Petitioners purchased the real property in the 1980's, so there is no doubt the property has appreciated due to the real estate climate in Idaho. However, to realize the gain from the property Petitioners would have to sell the property and that is not part of their business plan. As for the horses, the market may be better now than it was in 2008, but as in 2008, market volatility can be such that they cannot give the horses away.

Success in other similar or dissimilar activities: Petitioners claim their hog raising was successful, and it is quite possible Petitioners' hay operation was profitable in the beginning. However, those records are not available and if Petitioners were accounting for profitability in the same manner they currently look at profitability, the hog activity most likely was a loss once all farm costs and overhead are included. To Petitioners credit, they did consistently change their product to what they thought would make the farm profitable.

History of income and losses and occasional profits: As previously stated, Petitioners claim to have generated income in 1996, the last year of their hog operation. If this is true, it is one year out of 30+ years the farm was profitable. Throughout the years, Petitioners did make substantial investments in the farm. From the purchase of equipment to making real property improvements, Petitioners' investments far outweighed the revenue generated. Some of Petitioners' losses can be attributed to startup costs and infrastructure improvement and some of the losses can be attributed to things beyond their control like disease, death, predators, and depressed market conditions. Nonetheless, Petitioners were undaunted and continued the farm in spite of mounting losses.

Other sources of income: Petitioners have other significant sources of income that they can rely upon. In fact, Petitioners have benefited tax wise by the farm losses. The farm is not Petitioners'

main source of income and were it not for their passive income, Petitioners could not have sustained or expanded their farm activity. There is little doubt Petitioners intend and believe they can make the farm profitable, but without this constant infusion of cash Petitioners would likely not have the farm if everything else remained the same. Because of their passive income, Petitioners do not need to depend on the success or failure of the farm.

Elements of personal pleasure or recreation: Petitioners have a deep interest (mission like) in saving the draft horse breed. They believe the draft horse will play a vital role in the future of the country. Petitioners also believe their lifestyle of homesteading and being self-sufficient are skills that will be needed in the future. Petitioners argued that raising livestock, hogs, sheep, and cattle, is not pleasurable and the work is not easy with long hours and 24/7 duty. Nevertheless, Petitioners have embraced the small family farm lifestyle and take pleasure in showing their farm and sharing their 30+ years of learning skills to help others be more self-reliant.

Considering the information and documentation before it, the Tax Commission has difficulty seeing that Petitioners' farm/ranch activity is a for profit trade or business. The overwhelming factor for the Tax Commission is the fact that the activity has not generated a profit since 1996 and quite possibly never.

The standard for determining whether an individual is carrying on a trade or business is, did the individual engage in the activity with the predominant purpose and intention of making a profit. *Allen v. Commissioner*, 72 T.C. 28 (1979). That purpose may exist even in the face of a history of losses unaccompanied by any gains whatsoever, but the deductibility of those losses must depend upon the taxpayer's proven intention that he sought to realize a profit. *Bessenyey v. C. I. R.*, 45 T.C. 261 (1965). The taxpayer's expectation of profit need not be a reasonable one; it is sufficient if the taxpayer has a good-faith expectation of realizing a profit, regardless of the reasonableness of such

expectation. *Golanty v. Commissioner of Internal Revenue*, 72 T.C. 411 (1979). Whether a taxpayer engages in an activity with the requisite intention of making a profit is one of fact to be resolved on the basis of all the surrounding facts and circumstances of the case, and the burden of proving the requisite intention is on the taxpayer. *Golanty v. Commissioner of Internal Revenue*, Id.

A history of unexplained losses over an extended period is persuasive evidence of the absence of a profit motivation. *Allen v. Commissioner*, supra. A record of large losses over many years is persuasive evidence that the taxpayer did not expect to make a profit, and the unlikelihood of achieving a profitable operation are important factors bearing on the taxpayer's true intention. *Golanty v. Commissioner of Internal Revenue*, supra. However, if the losses occurred in the formative years of a business, it is not inconsistent with an intention to achieve a later profitable level of operation, bearing in mind, however, that the goal must be to realize a profit on the entire operation, which presupposes not only future net earnings but also sufficient net earnings to recoup the losses which have meanwhile been sustained in the intervening years. *Besseney v. C. I. R.*, supra.

Likewise, the fact that taxpayers have substantial other sources of income which permitted them to sustain the losses is not indicative of a profit motive. *Allen v. Commissioner*, supra. Enduring decades of losses is the sort of thing that can be done by a person of means unconcerned with making a profit currently or even ultimately, to say nothing of recouping large losses sustained over a substantial period of years. *Golanty v. Commissioner of Internal Revenue*, supra. Petitioners' income was sufficient to enable them to maintain a comfortable standard of living notwithstanding the losses from the farm/ranch operations. *Golanty v. Commissioner of Internal Revenue*, supra.

Petitioners provided a business plan for the farm but provided no projections of sales, revenues, or expenses. Petitioners' plan encompasses the years 2016 through 2025. Their plan includes moving to service and recreational endeavors but still producing food products. Their plan

also includes adding significant real property improvements. What their plan does not include is how these things will be funded.

Petitioners kept books and records on the farm, but there is no indication they were kept for the purpose of cutting expenses, increasing profits, and evaluating the overall performance of the operation. *Golanty v. Commissioner of Internal Revenue*, supra.

Petitioners stated they changed their operations, livestock, over the years by abandoning unprofitable animals with an intent to improve profitability with others; although they never fully abandon any of the livestock they started to raise. The changing of methods, techniques, species, etc. can indicate a profit motive. *Allen v. Commissioner of Internal Revenue*, supra. However, with the exception of raising hogs, Petitioners never grew the numbers of the other livestock for the operation to become profitable.

Petitioners argue the appreciated value of the farm/ranch is far more than their accumulated losses. This may be true, however, there is no evidence indicating that Petitioners acquired the property for the purpose of subsequently selling it for a profit; nor is there evidence that Petitioners have ever contemplated selling the farm so as to defray some of the costs of operating the farm. *Golanty v. Commissioner of Internal Revenue*, supra. The appreciation in value may offset the aggregate operating losses, but there is no evidence Petitioners thought about the prospect of realizing a profit on the sale of the farm when they decided to purchase the property, begin the farming activity, and continued to sustain operating losses. *Allen v. Commissioner of Internal Revenue*, supra.

There is no question that the act of raising livestock entails long hours, hard work, sleepless nights, and unpleasant chores, which equates to not a lot of pleasure or recreation. However, the Tax Commission sees that Petitioners have a passion for the farming lifestyle and living off the land. They gain personal satisfaction in perpetuating their draft horse of choice the Petitioners

also find pleasure in sharing and teaching the skills they have learned over the past 30+ years.

Taking pleasure in or getting enjoyment from one's work is not inconsistent with a profit motive. Nonetheless, after reviewing the entire record and the facts therein, the Tax Commission is not convinced that Petitioners' activities were operated on a basis which supports a conclusion of a good faith expectation of profitability. Furthermore, based on Petitioners' business plan, the Tax Commission does not see that the situation will change.

CONCLUSION

Petitioners have been operating a farm/ranch since the late 1980's. It is questionable whether Petitioners' farm/ranch ever generated a profit. From the outset, Petitioners may have intended and continue to believe the activity can be profitable. However, based on the information provided, particularly the decades of substantial losses and Petitioners' substantial income from other sources, the Tax Commission cannot say in good conscience the activity rose to the level of a for-profit activity. Therefore, the Tax Commission upholds the Bureau's determination that Petitioners' farm/ranch is a not-for-profit activity.

The Bureau added penalty and interest to Petitioners' tax liability. The Tax Commission reviewed those additions and found the penalty inappropriate, but that the interest was correctly added. See Idaho Code section 63-3045.

THEREFORE, the Tax Commission AFFIRMS as MODIFIED the Notice of Deficiency Determination dated March 11, 2021, directed to

IT IS ORDERED that Petitioners pay the following tax, penalty, and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2016	\$9,484	\$ 0	\$2,622	\$12,106
2017	31,211	0	7,602	38,813
2018	8,399	0	1,686	10,085
2019	8,631	0	1,267	<u>9,898</u>
			TOTAL DUE	<u>\$70,902</u>

Interest is computed to June 1, 2024.

An explanation of Petitioners' right to appeal this decision is enclosed.

DATED this _____ day of _____ 2024.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2024,
a copy of the within and foregoing DECISION was served by sending the same by United States
mail, postage prepaid, in an envelope addressed to:

Receipt No.
