

Farming Records and the IRS

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The accuracy and businesslike nature of records is something that the IRS has been scrutinizing more and more in recent years. The IRS expects all taxpayers to maintain canceled checks, invoices, credit card statements and similar items needed to substantiate amounts claimed as business deductions and to help prepare one's tax returns.

In addition, people in the farming, ranching and horse industries are expected to maintain a variety of day-to-day business records to show the businesslike nature of their activities, in order to withstand scrutiny under the IRS hobby loss rule. The IRS will take the position that if you have a significant history of losses, you are not engaged in a trade or business and that you are simply taking business deductions to reduce your taxable income from other sources.

What sort of records are appropriate or helpful in this regard for farmers and ranchers? First of all, it has been increasingly important, according to recent Tax Court decisions, for taxpayers to have some sort of written business plan. The purpose of a business plan is to set forth your strategy for making a profit in your farm, livestock or horse venture. Business plans can be simple or complex and usually should have financial projections. There are many books and internet resources to help people prepare a formal business plan and often people will turn to professionals to help draft the plan. Your plan should be modified periodically to show that you are responsive to

changed circumstances that make it prudent to modify your direction.

In addition to examining the records you keep, the IRS may want to visit your farm or ranch to see whether it appears to be conducted in a professional, businesslike manner.

For owners of horses, cattle and other animals used in the venture, it is important to maintain files identifying the number of animals owned and, to the extent possible, the date of purchase, sale prices, breeding data, horse show entry dates, racing results, and so on. And of course records of sales, promotional efforts, copies of advertising and other information pertaining to sales should be maintained.

It is helpful to maintain records to show consultations with experts in the farming or ranching industry and action taken as a result. Consultations, for instance, to implement a fertilizing program, to prevent soil erosion or other measures taken to improve soil quality, should be documented.

The IRS also may inquire about animals that are not productive or which are not being used for breeding, showing or racing purposes. For example, if an animal has become ill and has incurred significant veterinarian fees, the question is whether this animal is going to be laid up for a long time, and whether it might be prudent to sell the animal or donate it to a school or other equine charity. By doing so, you are showing that you

are mindful of the costs of keeping an animal that might not be productive and that you are reducing your costs by culling the animal from your inventory.

It is important to keep signed copies of all documents, such as leases, sales agreements, contracts, partnership agreements and so forth, rather than unsigned or draft copies. Also, it is important to keep some kind of log that shows the amount of time you expended in the activity on a weekly basis. This can be something as simple as a desk calendar or a more complex computer format. It should be kept as current as possible. Often the IRS will question how someone who has a full time occupation such as a physician, investment broker, lawyer or other professional, can afford to put in time to attend to the activity, and keeping a log will help substantiate and prove the fact that you put in a certain number of hours per week.

Another type of record that is extremely important consists of appraisals of farmland. This is helpful in showing that improvements and other elements have helped the property increase in value and is a factor considered in the hobby loss rule. Appraisals should be made of bloodstock used in the venture--for instance, the increase in value of broodmares or stallions should be documented. The appraisal should be from a bloodstock agent or a trainer.